Knowing Where You're Going

FOUNDERS CAPITAL MANAGEMENT
2015 ANNUAL REPORT

Investing for the Long Term. Every Day.

An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2015 Annual Report:

“Knowing Where You’re Going”

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PRINCIPALS' LETTER
From: Founders Capital Management

2015: Knowing Where You're Going

For most investors, 2015 ended on a flat note. Although the final result seemed lifeless, we can say that the past year was anything but a humdrum ride for market participants. Like a roller coaster, the market bounced up, down, and all around for 12 months, only to end near where it had started. Throughout the year, global investors continued to contend with European financial and political turmoil, unrest in the Middle East, shaky financial ground in Japan, and an ongoing economic slowdown in China, all of which may impact the future growth of the U.S. economy. In addition, terrorism kept entering the fray, creating further unrest and uncertainty. Despite all this turmoil and some movement toward a global industrial recession, a resilient U.S. market has not lost the gains made since the economic meltdown of 2008. Once again, the U.S. market seems to be the safest house in a challenging global neighborhood.

The Standard & Poor's 500 (S&P500) total return, including dividends, rose 1.4% in 2015. Most market participants seemed dissatisfied with this result. In contrast, we regard the past 365 days as a "market rest" after the S&P500 posted double-digit annual returns the previous five years. Nonetheless, frustration with this year's market outcome was to be expected—patience is no longer an investor's virtue, as many became accustomed to consistent annual price gains after the financial turmoil of 2008. A majority of today's investors who take risk with money in the market seem to feel entitled to reward—and regard no reward over a full year's period as a setback.

Once again we are at a crossroads, and many investors are wondering which way the market will go—backward down a path of despair, or forward down the path of prosperity. As detailed in this year's letter, we believe we are on the path to prosperity and choose not to look in the rearview mirror of misery and hopelessness. This positive view is not based on our prediction of the market's future price movement, but rather on the prospects for the great companies we own that make up the Founders portfolio.

As a backdrop to this year's letter, it is important to keep in mind that the economic recovery we have experienced since the 2008 financial crisis continues to gain momentum, even though the pace slowed in 2015 almost to a crawl. The "flat" U.S. market of 2015 reflects this temporary economic slowdown. Amid the temporary slowdown, investors nevertheless continued to seek returns through overspeculation, and the bifurcation between "old ironside" companies and "new age" enterprises further widened. Our rationale for "not following the crowd's money," how we are managing our current positions in a more challenged investment environment, and why we are confident in our approach are the focus of this year's letter.

The theme of our 2015 letter is "Knowing Where You Are Going," and our topics include:

- The Knowable vs. Unknowable
- Measuring Intrinsic Value
- Discerning Value from the Valuable and Invaluable

The Knowable vs. Unknowable

> **"Tell me where I'm going to die, that is, so I don't go there."**
> ***—Charlie Munger***

It is human nature to attempt to forecast the future. Perhaps this impulse is a defensive mechanism that provides us a sense of security, or necessary to motivate us to work toward a desired outcome. Either way, if the propensity to forecast is innate, it is important to use filters to differentiate between what is more certain vs. less certain—in other words, we first need to understand what is knowable vs. unknowable.

Warren Buffett's business partner, Charlie Munger, sums up the knowable vs. unknowable dilemma in the quote that leads off this section—if we were able to know where we were going to die, obviously we would avoid the destination. It is fascinating how many market participants knowingly choose to go to the investment graveyard by making baseless predictions about future prices of the market or specific stocks.

We believe that investment success and failure do not stem from forecasting about the future, but rather from an ability to distinguish between what is knowable and what is unknowable. For example, do we know for certain that the economy is going to grow 3% or more in 2016? Are we positive that Amazon.com and Netflix— whose stock prices increased more than 100% in 2015—are going to continue to climb next year? We can all place our "bets" on the answers, but in the end, hand on heart, we cannot admit that our forecast is based on information that is knowable. In fact, our prediction is likely based on a hunch, or on an educated guess based on information that is unknowable.

Several times each year, we are asked to participate in a committee that evaluates investment presentations given by money managers. After each presentation, 100% of the time, the discussion focuses on the pricing activity of represented companies in the portfolio, as opposed to the intrinsic value of the underlying businesses. Everyone seems more interested in discussing the unknowable deviation of securities that went up (or down) significantly in price compared to the norm, instead of discussing the more knowable—i.e., the business prospects for each company. In one instance, a committee member stated that the managers' portfolio should be invested "more aggressively," as opposed to what he viewed as conservatively, where the price deviation of the purchased securities was "too much in the norm." Our interpretation: This investor was seeking more uncertainty among the holdings because, in his view, a lot of unknowable price movement equates with potentially higher returns.

It happens to be our experience that, more often than not, uncertainty equates with lower aggregate returns over time. Why? Because any "winning" positions selected that temporarily appreciate in price are offset by positions that deliver a loss. To make matters worse, this type of portfolio can also be vulnerable to a permanent future loss, when the high-flying positions eventually come back down to earth while the losing positions continue their downward spiral. In the investing game, one can never "have your cake and eat it, too." Once you go down the speculative path of equating uncertainty with higher returns, you subject your portfolio to unknowable extremes—which will translate mostly into losses.

Our investment approach is to evaluate "comparative certainty" as opposed to "proportional uncertainty." We place primary importance on evaluating what is more knowable and certain, as opposed to scattering portions of money around various unknowable and uncertain "opportunities," hoping to achieve a better-than-average result.

In the current investment environment, it is critical to be mindful of the tendency of many global market participants to weigh heavily on a forecast of future prices (i.e., the unknowable and uncertain) in the pursuit of increasing gains—an approach that is leading investors to overspeculate. We now see this "stretch" happening across all facets of investments. For example, the employee of one Fortune 500 company filed a lawsuit for "pushing the boundaries" based on the company's investment of nearly 7% of its multibillion-dollar retirement portfolio in areas such as commodities, private equity funds, and hedge funds. In the case of a pension fund, investment elasticity is unnecessary given this vehicle is supposed to exist in perpetuity. Amateur and professional investors alike are actively pursuing popular stocks and alternative investment vehicles because they supposedly have a tremendous future, or simply because they are being chased by others. Investor

excitement (and disappointment) continues to churn around stocks such as Amazon.com, Netflix, Facebook, Groupon, Zynga, LinkedIn, Pandora, Zillow, Yelp, and Twitter, to name just a few.

Since our 2012 annual letter, we have been following the course of social media stocks. Last year, we reported that the collective market value of social media-related companies had risen approximately 28% in 2014, to $289 billion. This year, the collective market value of these same securities has risen 22.8%, to $355 billion. Investors are now paying an estimated $355 billion for this group of businesses that will produce around $1.7 billion in reported profits during 2015—which translates to 208 times Generally Accepted Accounting Principles (GAAP) earnings. (Facebook's earnings of $2.6 billion once again leaves a combined $900 million loss for the remainder of the group.)

This brings us to our annual update on social media issues:

	Market Cap at IPO Price *($ billions)*	Market Cap 12/31/2015 *($ billions)*	Gain / (Loss) since IPO	Price / Revenue 12/31/2015	Price / GAAP Earnings 12/31/2015
Facebook	82	296	261%	16.9x	112x
Groupon	13	1.9	(85%)	.62x	Loss
Zynga	7	2.5	(64%)	3.4x	Loss
LinkedIn	4.8	29.5	514%	9.8x	Loss
Pandora Media	2.5	2.85	14%	2.4x	Loss
Zillow	.66	4.3	561%	6.6x	Loss
Yelp	.95	2.17	128%	4.0x	Loss
Twitter	14	15.8	13%	7.1x	Loss

Like a broken record, we repeat: The concern with these so-called opportunities continues to be valuations that are totally dependent on prospects yet to be realized. To us, it makes little economic or business sense to purchase a portion of a company that does not have a predictable earnings stream—let alone losses—compounded by no sustainable competitive advantage. It is our opinion that many of the companies that have attracted large amounts of investment in recent years, such as social media entities, lack the critical investment attributes of being "knowable" and "certain." Note that, outside of Facebook, whose stock price increased 33.4% to drive this group's market cap gain in 2015, stock prices of the remaining social media companies fell:

	Select Social Media Companies: Gain / (Loss), 2015
Facebook	33.4%
Groupon	(61.7%)
Zynga	(1.8%)
LinkedIn	(2%)
Pandora	(24.3%)
Zillow	(19.5%)
Yelp	(47.8%)
Twitter	(36.7%)

Consider this: An investor who had placed $10,000 in Facebook and the other seven companies in the preceding table at the beginning of 2015 (creating a total social media portfolio of $80,000) would have been left with $63,955 at the end of 2015 —suffering an aggregate loss of (20%).

Since we are pointing out investment folly in the current social media space, it is only fair that we point out the speculative behavior and boundary-stretching taking place among so-called value investors. For example: Valeant Pharmaceuticals epitomizes a company that many high-profile value investors have purchased over the past few years (even value investors can be herd-like). Value investors love companies that produce a lot of cash, and Valeant Pharmaceuticals' business model was set up to gush money by exploiting the outdated business model of today's typical pharmaceutical company. These "old-school" pharmas typically invest approximately 15% of revenues into research and development to ensure an ongoing pipeline of new drugs. The investment concept behind the Valeant model is to acquire these outdated pharmaceutical "dinosaurs," eliminate the acquired company's R&D operations, and raise the prices of their existing drugs. Voilà—Valeant turns into an ever-increasing cash-generating machine from which business analysts forecast rising profits as far as the eye can see, as over time, Valeant takes over the pharmaceutical industry—until the government steps in and questions the practice of aggressively raising drug prices, and investors question how a company can produce future drugs without making a significant investment in R&D.

So what happened with Valeant? In four years—the approximate amount of time between the founding and IPO of a typical social media company cited in the previous table, Valeant's stock price rose from $50 per share in 2011 to more than $250 per share in August 2015. Subsequently—in less than five months—the stock fell more than 60%, and a great debate is ongoing among many value investors regarding this company's true worth. Yet any investor could have avoided an allocation of capital to Valeant if they had focused on understanding what is *knowable and certain*, as opposed to what is *unknowable and uncertain*. Valeant's business model—not unlike many social media companies we have cited—does not appear to be rock-solid. It is our opinion that Valeant's way of operating is not economically feasible or sustainable for a pharmaceutical company. Valeant's touted "recipe for success" can be easily duplicated by other drug companies—and likely would have been copied if this company's business model had been viable. This is the main reason to avoid an investment in Valeant.

Founders' response to all this speculative behavior has been to stay focused on what we believe to be more knowable and certain, as we watch increasing uncertainty and complacency enter both the equity and fixed-income markets.

Caveat Emptor—A Reluctant Forecast

Although we avoid macro forecasting (since we have no idea about the short-term direction of the stock and fixed-income markets and therefore are apt to be wrong), current market behavior leads us to believe that investors may be facing a challenging investment environment during the next decade based on two premises:

1) **Rising interest rates:** It is inevitable that, in the future, interest rates will move upward from their current near-zero status—perhaps higher than one may think. Rising interest rates act as an anchor on income-producing assets. For example, most fixed-income securities that have risen considerably over recent years due to lowering interest rates are beginning to stall, as indicated by the small gain of .32% in 2015 of Barclay's U.S. Aggregate Bond Index, which represents the broad debt market. We emphasized in previous letters that the yields being offered on fixed-income securities would definitely not provide outsize returns going forward—and this now seems to be taking place. In addition, due to low interest rates, many market participants have moved into low- to no-income producing, smaller-capitalized, and speculative equities that are now trading at exceedingly high valuations. The considerable rise in price of these securities over the past few years indicates an imbalance between risk and return in these financial instruments.

2) **Excessive government and consumer debt that has accumulated over the decades will need to be "absorbed" as interest rates rise:** The consequences of mounting government and consumer debt over the past few decades is not presently felt because low interest rates have allowed these large obligations to be serviced with minimal effort. For example, banks are currently reporting "pristine" customer credit quality, alongside the lowest-reported loan charge-off rates (which represent defaulted loans) in several decades. This scenario will likely change as interest rates begin to rise and loan payments commensurately increase on consumer debt that resets at higher rates. At some point, mounting debt may become a serious issue—causing governments and consumers to aggressively pay down their debts—as opposed to allowing the cost of their obligations materially rise, or eventually face default.

What Should Investors do During this Challenging Investment Environment?

The answer: Focus, focus, and focus!

It is vital for investors to:

- focus on the reality of the investment environment in front of us
- focus on the intrinsic value of our holdings
- focus on the discipline of allocating and reallocating capital effectively

At Founders, the following points of focus have not—and will not—change:

1) During challenging times, Founders first and foremost plans to sit tight on our core holdings, which will allow us to escape the emotional activities permeating markets and influencing individuals to trade rapidly and often in a frenetic pursuit of returns. We believe that there is no way to effectively trade in and out of the market or associated securities, and that "portfolio churning" amounts to an accident waiting to happen. We can say with conviction that almost all individuals who practice this dubious art eventually end up in ruin.

2) Founders will continue to understand exactly where we are placing our money. We will strive to avoid falling victim to predicting short-term stock price behavior, or rear view-mirror thinking, where hindsight trends are used to anticipate future prices. We humbly acknowledge that we have little to no ability to "call" the right direction of the market—or, for that matter, the price of a particular company's stock.

This holds especially true for investing in opaque securities that we do not understand. We will "stick to our knitting" and only acquire companies that we know in-depth and that are positioned to gain strength in any economic environment. We will focus on what is knowable and important, as opposed to what is unknowable and unimportant—essentially, we are determined to remain focused on what we believe to be more certain.

3) Founders will continue pursuing our education—striving to be passionate and curious learners, discovering interconnections within our holdings, and seeking collective knowledge to understand the value of the assets we own. During volatile times, it is essential that we ignore any inclination to evaluate our activities against those of "market gamblers" or to join investment "crowdthink." Instead, we will focus on the ability to calculate the approximate long-term value of the assets in our portfolio. Doing so will shore up confidence that the securities we hold possess sustainable competitive advantages and enduring potential value, allowing them to grow far into the future.

At Founders, we care deeply about the money individuals have entrusted to our stewardship. We view our clients as partners, and our investment activity is interdependent—in other words, we eat our own cooking. We hold tightly to our value investing philosophy, and we seek to invest where intrinsic value grows over time. And we always act with honesty and integrity—there is no other way.

Since we are unable to provide exact answers to questions about any market's near-term direction and will not be influenced by the frenetic "emotional investing" that occurs in the equity and fixed-income markets, we will remain agnostic to any market's short-term movements. Instead, we will remain patient, and keep our eyes open for opportunities that emerge in a volatile environment, keeping in mind one of our favorite Warren Buffett quotes:

> **"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."**
>
> ***—Warren Buffett***

We remain confident that the securities we currently possess will provide a fair return over time, despite gyrating markets and higher-than-normal speculation. This includes investments in selected fixed-income instruments that offer a commensurate risk/reward relationship, as well as acquiring interests in strong individual companies through the equity market that are very profitable and have a wide competitive moat. Our investment approach in all market conditions reminds us of another favorite Warren Buffett quote:

> **"We will continue to price, rather than time, our purchases. In our view, it is folly to forgo buying shares in an outstanding business whose long-term future is predictable, because of**

short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?

—Warren Buffett

Measuring Intrinsic Value

"Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life."

—Warren Buffett

Year after year in our annual letter, we have overemphasized the importance of understanding the intrinsic value of the securities we own. Given that we repeat this every year, we'd like to explain our view on intrinsic value so that our clients fully comprehend the foundation to our investment approach.

A Simple but Complex Concept

The previous Warren Buffett quote sums up the calculation on intrinsic value for a business. The intrinsic value of a business is equal to the discounted value of the cash that can be taken out of a business over its remaining life—without affecting its need for capital to grow. There are various formulas and methods for figuring intrinsic business value; we will use a straightforward calculation to illustrate this concept. (It is necessary to interject some math at this point— please forgive us.)

Since we like the candy business due to its highly predictable nature, we will use this as an example: Suppose we own Candy Co., which is expected to earn $2.50 per share, of which $2 may be freely distributed to owners without impacting the company's ability to grow into the future. In other words, 50¢ per share will be maintained by the company to reinvest in the business to support future growth opportunities. If our candy business is able to indefinitely earn 25% on each $1.00 it retains, then we can calculate a prospective growth rate of 5% between now and eternity for our business. The equation:

[(50¢ kept within the business ÷ $2.50 earnings = 20% of earnings retained) x 25% return on the retained portion = 5%]

We are not done yet. Conventional financial practice then applies a rate of interest to discount (called "discount rate") our perpetual 5% growth on freely distributable Candy Co. earnings. A higher interest discount rate is used by the investor to compensate for the risk inherent in placing money in a more uncertain business, as opposed to purchasing a secure government bond. So, if an "average" 10-year U.S. Government Bond were to offer an investor a 6% return over time, then someone interested in purchasing shares of Candy Co. would want more than the 6% risk-free rate to place their money in a situation that carries greater inherent risk. Let's say a purchaser wants a 4% premium to the 6% average 10-year government bond rate to compensate for their risk— they would then use a discount rate of 10% to figure a purchase price for each share.

Now, for the grand finale: After tumbling the previous numbers, a purchaser would likely offer to pay around $40 per share for Candy Co. The full calculation of intrinsic value would be as follows:

[$2.00 distributable earnings ÷ (the 10% discount rate minus a 5% growth rate to perpetuity), or ($2 / 0.1-0.05 = $40)]

A note to readers with a finance degree:
We put aside the rear-view mirror, WACCy financial calculations taught in business schools when figuring the appropriate discount rate on business investments. We believe it makes sense to use an approximate opportunity cost for putting our money at risk as opposed to a precise, moving-target figure based on current interest rates, along with an uncertain calculated regression that relies heavily on past information regarding stock price volatility that is likely to be wrong in the future.)

Regarding the Candy Co. example, we can see that, although the logic of intrinsic value is rather simple—i.e., measuring an investment's worth by how much money one can get out of it—ultimately, the calculation itself is not easy. (If it were easy, all investors would be rich.)

Why can the measurement of intrinsic value be so difficult? Because of the many uncertain variables involved in the calculation.

Any given group of professionals tasked with individually evaluating the details of a business will invariably reach different conclusions about the company's valuation based on a number of factors, including different estimates on future profits, capital requirements, interest rates, and projected growth rates.

For example, everyone intuitively understands that a company's freely distributable earnings are not ironclad and will be subject to "bouncing around," based on the cyclical nature of the business and/or the economy. This is especially true for capital-intensive businesses that are subject to greater swings in earnings because they are extremely sensitive to the economic climate, both positive and negative. For example: In an uncertain economy, consumers will delay purchasing an automobile and/or a large appliance, then buy these items en masse when feeling flush during good economic times. This is the reason the stock prices of many cyclical businesses fluctuate greatly. In the end, most businesses to a varying degree are subject to a bounce-around earnings pattern, even the more "consistent" ones that produce less expensive, more predictably purchased products such as candy, soap, and soft drinks.

The estimate of intrinsic value also fluctuates as interest rates ebb and flow, given this changes the present value of a dollar received in the future. To cite an extreme example, in the case of Candy Co., the opportunity cost of discounting future distributable earnings at 10% can be questioned if risk-free interest rates rise above 10%. (Given the low 2.27% rate offered on a 10-year U.S. Government Bond at the end of 2015, many investors don't think high rates will appear again during our lifetime—but this was a commonly held belief in 1962, when the 10-year U.S. Government Bond yield was approximately 4%—and steadily rose to 15% by 1982). Many financial pundits may point out that this is where the previously mentioned WACCy financial theory succeeds—via an automatic adjustment in the discount rate under changing financial circumstances. But, our experience makes us highly suspicious of most prescribed financial formulas used to calculate the value of a business dollar today that you are projecting to receive in the future. This is especially true when the formulas use a combination of present-day and rear-view mirror variables that become quickly outmoded. You are certain to be wrong. Thus, when interjecting current interest rates along with a risk premium to ascertain a discount rate, you can end up with a very gray intrinsic value figure—represented by a moving target composed of many black-and-white variables. This is another reason it is advantageous for investors to think of intrinsic value in terms of a range.

There is one aspect of the traditional definition of intrinsic value that is correct in theory but needs closer scrutiny in practice, since it can be a prelude to folly: Investors should question the logic of forecasting cash that can be taken out of a business over the company's "remaining life." Projecting the near-term money that can be removed from a business is difficult enough, but forecasting the cash to be removed from a business 80 to 90 years down the road is impossible. The combination of variables required to forecast cash available to owners (e.g., projecting a company's far future growth, capital requirements, competitive position, and earnings) become elusive with changes in the economic and business landscape as well as changes in society. Arriving at a highly probable prediction about the cash that will be distributable from a business 90 years down the road requires very predictable inputs—otherwise, the projected number could lead an investor down a dangerous path.

We find it useful to apply the "forever test" whenever we begin to think a business can be forecasted far into the future. If we could go back to 1926 and project the far-future owner earnings of the companies that constituted the Dow Jones Industrial Average and were considered to be "the best of their time," we would have had a high probability of being wrong. Here are the companies that made up the Dow Jones Industrial Average in 1926—most cease to exist today.

Allied Chemical	International Harvester
American Can	Mack Trucks
American Car & Foundry	Paramount Famous Lasky
American Locomotive	Remington Typewriter
American Smelting	Sears Roebuck & Co.
American Sugar	Texas Company

American Telephone & Telegraph	U.S. Rubber
American Tobacco	U.S. Steel
General Electric	Western Union
General Motors	Woolworth

This illustration is instructive for would-be value investors. If we were teaching a class of MBA students and wanted to develop an investment course for 1926 knowing what we know today, would we suggest that students value these topnotch companies based on predicting the cash to be removed from those businesses over the next 90 years? The answer is clearly *no*, given the changes that occurred in these businesses, in the economy, and in society over the past 90 years. Therefore, shouldn't we avoid using this same logic to value the companies that constitute the Dow Jones Industrial Average today?

Understanding this "financial model flaw," what should an investor focused on measuring intrinsic value do? Since we have a difficult challenge forecasting a company's owner earnings over the next decade, and near-zero probability of projecting owner earnings 80 or 90 years out, what time period should we use?

A Simpler—But Still Complex—Concept

One approach would be to "triangulate" intrinsic value by assessing the owner earnings one can forecast over a more realistic period of years, or an "investment horizon."

We believe that investors should seek an investment horizon that is closely related to a more viewable business period when valuing a company – let's say five to seven years. In addition, they should also calculate the value of a business using comparable returns available on a risk-free investment—usually the *average* long-term, risk-free return on government issues. *A precursor to our thesis: We understand that no model is perfect and the investment horizon can ebb and flow due to changes with a company's outlook, as well as key factors that may impact interest rates, such as a change in long-term inflation expectations.* Thus, the potential value of a company reflects the owner earnings that can be forecasted for a business in a viewable business period (let's say five years) times the inverse of the average risk-free return available in a government bond.

Unfortunately, there is more math. Here's a simple formula we use for ascertaining intrinsic business value:

$$\mathbf{IV = [P_0(1+r)^n \times 1/\mathit{tr}]}$$

IV is intrinsic value
P_0 is adjusted calculation of owner earnings today (or "free cash flow")
r is the rate of growth in owner earnings
n is the number of compounding periods (years)
1/*tr* is the inverse of the average long-term, 10-year government bond—represented by ***tr***

Let's look at an example using this "short" method for determining intrinsic business value:

Suppose we calculate that U.S.-based Candy Co. will produce $800 million of owner earnings in 2015 and believe that, based on the company's prospects and reinvestment activity, owner earnings will grow 8% per year over the next five years. The intrinsic value of Candy Co. would be as follows, assuming a long-term U.S. Treasury rate of 6.25%.

$$[\ \$800M(1+.08)^5 \times 1/.0625\ ] =$$

$$\$1{,}175m \times 16 =$$

$$\$18{,}807M$$

In contrast, the "conventional" intrinsic valuation method outlined in the first paragraph of this section would be as follows, assuming Candy Co. can grow forever at 6% and discounting future owner earnings at a rate of 10%:

$$(\$800M\ /\ 0.1- 0.06\ ) =$$

$$(\$800M/\ .04) =$$

$$\$20{,}000M$$

So what is the current valuation of Candy Co. according to the market? Let's assume that the year-end market cap for Candy Co. on the New York Stock Exchange was $19,353m—so results from both the "short" and "conventional" intrinsic valuation methods are "in range." However, the "short" method for measuring intrinsic value prompts the investor to weigh heavily on a near-term business focus, while taking into consideration long-term prospects. In contrast, the "conventional" method prompts the investor to heavily assess many variables that are elusive and largely "out of sight."

The "short" valuation method even helps in evaluating a business like Amazon.com. Analysts expect Amazon.com to grow owner earnings from approximately $5,500 million in 2015 to $20,000 million in 2020. Using our short formula, if this growth in owner earnings were achieved, then Amazon.com's intrinsic business value would be approximately $320,000 million. Amazon.com has a year-end market value of $317,000 million, so the market's thoughts on Amazon.com's value seem to be based on analysts forecast.

Let's compare Amazon.com to Walmart, which is currently out of favor with investors. Walmart will produce approximately $12,500 million in adjusted owner earnings during 2015 and is expected to grow owner earnings between 3% and 4% per year over the next five years—to around $15,000 million. Using the short valuation method, Walmart's intrinsic business value would be around $240,000 million today. Walmart's year-end market cap was around $196,000 million and appears to be trading at an approximate 18% discount to a conservative estimate of its intrinsic business value.

While we are not stating with certainty that Amazon.com's intrinsic business value is $320,000 million or that Walmart's is $240,000 million, we can ask questions about the large disparity in value assessed by the market for these two retailers. What are the chances that Amazon.com has the capability to quadruple its revenues and earnings in the next five years to nearly equal Walmart's current sales and earnings (assuming a similar net profit margin)? If we believe the certainty of this occurring is high, then Amazon.com's current valuation can be supported. On the other hand, if we believe that the certainty of Amazon.com's projected five-year growth and profitability is low, then the market's valuation of Amazon.com is too high. Conversely: How do we compare Amazon.com's and Walmart's e-tailing vs. retailing business models, and can Walmart successfully incorporate an online shopping experience with its customers? If Walmart is able to incorporate e-tailing into its brick-and-mortar customer retailing experience, then the market's current valuation of Walmart may be too low. Clearly, the short valuation alternative allows comparative and alternative-based thinking in the valuation process, which can be telling.

In summary: We are very aware that the "short" method of measuring intrinsic business value flies in the face of any "conventional" method that favors the more complex. We have used all the available models over the years, but have found that it is more important to be approximately right as opposed to precisely wrong. Many times, the models that work best are ones that allow an investor to focus on the "right" business questions to support financial inputs, as opposed to moving around a lot of financial variables using regressions that have little to do with the business, in order to achieve a desired output. Consequently, we find a short valuation method useful as a complement to the conventional method of measuring intrinsic value for the following reasons:

1) The short valuation method forces us to focus on the cash that a business is producing today, as well as our analysis regarding the cash that a business is capable of producing during the current business cycle—i.e., five to seven years. This minimizes errors that can be made when forecasting cash flows more than a decade out—or, for that matter, 90 years down the road.

2) The short valuation method also forces us to focus on our expected growth rate for the business over a viewable business period by asking questions that pertain to the business and its industry. In addition, we can isolate the short-term and long-term growth (or decline) expectations for the business by the investment community, and make an educated assessment as to whether or not this rate is feasible. We can then make an educated comparison between our conclusions about intrinsic value vs. those of other investors.

3) We arrive at intrinsic value using the average long-term, risk-free U.S. Treasury Bond—usually the 10-year rate. This allows us to compare today's intrinsic business value using an average long-term, risk-free rate vs. the current risk-free rate and helps develop our assumptions regarding the margin of safety inherent in our business valuation.

One other important point: If a business is extremely capital-intensive (for example, the heavy machinery industry), investors understand that not all earnings in the income statement represent actual cash available to the owners due to a necessity to reinvest a large amount of the profits back into the business. In addition, if the business is very cyclical (i.e., impacted by economic conditions), the earnings of a capital-intensive company greatly fluctuate, and distributable cash to shareholders quickly dissipates if the industry or economy falters. We understand in these cases that adjustments need to be made, and we need to normalize owner earnings to correctly calculate intrinsic business value—for example, in the current cases of Caterpillar and John Deere.

Conversely, a business that is not as capital-intensive or economically sensitive (for example, the candy industry) produces a lot of money, and the earnings reflected in the income statement are more consistent and largely available to owners. These companies thus have a tendency to sell at more stable valuations because the cash available to owners over the investment horizon is more consistent and predictable. Of course, in all cases, distributable cash to owners, growth of owner earnings during the defined viewable business period, as well as changes in average long-term interest rates are important ingredients to assessing the ultimate intrinsic value of a company.

In this discussion about calculations used to measure current intrinsic business value, we must emphasize that, while all this quantitative analysis is necessary, it is not sufficient. We should also ask about the value inherent in a business beyond the five-year horizon.

This leads us to the most difficult part: When considering an investment in a business, we may have an idea of the intrinsic value today, but we should have a desire to understand the intrinsic value of the business five or 10 years hence. As such, we would need to focus on longer-term attributes (going out 10 or more years) and ask questions to assess the approximate future intrinsic value of the business:

- What are the interesting long-term prospects for the business?
  (How and where can it grow over the long-term?)
- How predictable are these prospects for the future?
  (How certain are we that growth is attainable?)
- What price are we willing to pay for the future prospects inherent in the business?
  (How much are we willing to pay for this longer-term growth today?)
- How well does management allocate capital that is retained in the business?
  (What are the expected returns on incremental invested capital in the business?)
- How is management's ability to allocate excess capital favorable to long-term shareholders?
  (How much money will management share with shareholders?)

Sticking with our Candy Co. example, some questions that would help us evaluate the long-term value creation for the business include:

- What is Candy Co. doing to grow its business over the next 10 or more years?
- Where will it grow?
- How predictable are the prospects for this growth endeavor, and how much more are we willing to pay for this growth today?

And finally, we would need to ensure that Candy Co.'s management is allocating capital effectively—within the business to obtain equal or better returns on capital than achieved in the past, as well as sharing with shareholders any excess capital that is not needed for growing its business—either through increasing dividends or share repurchases.

In summary: An investor should be familiar with the company that interests him and should be comfortable with the industry, the company's competitive position, and the organization's management. An investor who is not able to assess these attributes should pass on the opportunity to allocate money to that business, since he does not truly understand the investment. Once an investor is familiar with a business, assesses a range for intrinsic value and the return he is seeking, he should ignore the ups and downs of the general stock market and wait for the price to reach a "comfort zone" when taking advantage of a deal. When a business' share price reaches a point at which the company is "on sale"—i.e., selling at a good discount to intrinsic business value

—making a purchase at this point provides an opportunity to obtain a fair return on an investment over a long period of time.

Discerning Value from the Valuable and Invaluable

We have emphasized in the past the all-important investment concept known as the "margin of safety" and how it is principally achieved through purchasing a security at a discount to its intrinsic value. Although this is a cornerstone theory for value investors, there are pitfalls to pursuing companies that seem to be trading at less than their true value. An expansion of the margin of safety concept is needed to avoid a common "value trap."

Like Little Red Riding Hood, who was told by her mother to stay strictly on the path, value investors carefully stay on the road to picking up securities that trade at a discount to their intrinsic value—they maximize returns by purchasing $1.00 worth of value for 65¢. Unfortunately, in the process of gathering a below-value batch of securities to deliver to clients, there is a danger of placing spoiled companies in the basket. In the worst case, the decay spreads and creates devastation. The result –investment returns (and possibly principle) are devoured by the investment wolf.

This is a common problem, and value investors need to be careful when identifying value in each security they pick up to place in their portfolio baskets. We relate this cautionary tale based on our experience that most errors made by value investors occur in the purchase of securities that seem to have value but end up lacking the margin of safety that was believed to exist at the time of purchase—in reality, the value is elusive, and the business ends up being a "value imposter."

We have stated before that the largest risk associated with purchasing a business does not lie in the so-called discount to the business' intrinsic value, as this is a "best guesstimate." The largest risk resides in purchasing lower-quality businesses that look good today but, in the long run, have products that are highly susceptible to competition and an erosion of the business franchise.

All too often, a previously good business that has been studied for years falls out of favor with investors. This may present an opportunity, but in a number of cases, it has proven to be a curse. The investment graveyard is littered with businesses that were once great and are now moribund. Several current examples: Sears, JCPenney, and Avon. Each of these businesses was at one time attractive, based on current and future cash that was calculated to be available for distribution to shareholders. Some unwitting investors may feel confident that any of these companies will adjust to market changes and regain their supremacy—that they would not only survive, but in the meantime potentially return up to 10%, through a distribution of their cash flow to shareholders in a single year without skipping a heartbeat. Unluckily, after purchasing any of these enterprises at a supposed 35% discount to intrinsic value, the new owners are watching their cash go up in smoke, because these investors bought a soon-to-be-dead business without recognizing it until after the fact.

In hindsight—which is always 20/20—the mistake was obvious, and the catharsis begins. The point is, any value investor can become "brainwashed" once they have become accustomed to appraising good businesses over many years. The mind can become stuck with the original conclusion that the business possesses value—even after it has begun to slowly fail. The investor reasons that the recovery is just around the corner. After analyzing their errors and vowing never to repeat this blunder, many value investors do not seem to learn from their mistakes and repeat the process. Perhaps this is the "insidious trap" of a value investor.

To avoid falling victim to this error, we have learned to ask which basket our investment falls into: Value, valuable, or invaluable.

Value basket:

As we described previously, the value basket holds securities purchased at a discount in "fair-to-dying" businesses that have fallen in price, with the belief that the previous intrinsic value of the collapsed business will reemerge—when, in reality, the "real value" of our holding is decreasing day by day. It is safe to say that we want to avoid ever purchasing a fair-to-dying security or business that seems to possess inherent value that does not exist.

Valuable basket:

We are far more interested in purchasing securities in businesses that are positioned for long-term growth in intrinsic value, where the "real value" of our holding is increasing day by day. Examples of businesses that fall into the valuable category include CSX railroad, Chevron, and AT&T. Each of these businesses have solid business models that will likely grow slowly over time. Although these are valuable franchises, they are fairly capital-intensive and sensitive to the cyclical nature of the economy—and they are not going to "knock the lights out," with significant short-term growth. There are certain constraints that prohibit tremendous progress in these businesses, such as government regulations and limitations in geographic or industry boundaries. Nevertheless, if these infrastructure businesses fall out of favor and their stock prices fall well below intrinsic value, purchasing them can provide returns that can be favorable in the future.

Invaluable basket:

Nirvana is owning a business that is invaluable. This is a business that can grow worldwide for decades to come due to an entrenched market position, the transferability of its products, and a deep-rooted consumer monopoly that is almost impossible to duplicate. Examples of the few "Hope Diamond" businesses we believe fall into this category are Disney, Coca-Cola, and PepsiCo. In fact, the invaluable franchises are just that—invaluable—and are the most difficult businesses to value as the growth in their owner earnings can be considered immeasurable.

In the case of an invaluable business, financial models break down due to the perpetual growth in distributable owner earnings that can be forecasted decades out – although still difficult to predict. It is, therefore, important to value these businesses using conventional valuation methods, to avoid being carried away thinking that a "forever" business is good at any price. Otherwise, the investor's margin of safety erodes. Just ask any investor during the late 1960s and early 1970s, when the "make one decision to buy a great business, and never sell" approach took root among market participants— they bid up many of the then-called "Nifty Fifty" companies to more than 50 times their earnings, and most purchases at that level underperformed the market during the next 25 years. (Sears, JCPenney, Avon, Eastman Kodak, and Polaroid were all members of the original Nifty-Fifty business-inevitable list—that says it all about the dangers of forecasting a "forever" business.)

In summary, the most important question for investors focused on determining intrinsic value seems to be: What is the value of Company X, and what purchase point (discount) provides a margin-of-safety to obtain a good return over time? We think this is a very important question, but we believe it is equally important to understand different methods for determining the intrinsic value of a business, as well as correctly distinguishing between "value," "valuable," and "invaluable" enterprises. In our view, value investors can spend far too much time attempting to pinpoint a company's exact discount to intrinsic value, and too little time ascertaining what constitutes the valuable and invaluable aspects of a business that can provide an extra margin of safety.

In our management summary, we will outline the characteristics of the businesses we own that we believe make them valuable or invaluable and give us confidence in the future, regardless of what happens in the stock market.

* * *

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2015 Highlights

We kick off this year's equity holdings review in a manner similar to last year: We remain upbeat with our capital allocations, including expected returns over the next 10 years—even recognizing ongoing challenges.

Why can we say this? A few points we'd like to reiterate regarding our holdings:

- **We are confident in the high character displayed by the leadership of the companies in our portfolio** and think they are managed in a flexible manner that allows these businesses to adapt in changing times.
- **We believe that we are business partners in actual companies that are focused on increasing long-term profitability,** as opposed to being members of a group of shareholders that are interested only in a rising stock price that is divorced from a commensurate movement in business value.
- **We believe that we own a collection of business that fall into the "valuable" and "invaluable" categories and that their increasing intrinsic business value will be realized over time.**

As long-term investors, we truly wake up each morning knowing that the wonderful businesses we own—Coca-Cola, PepsiCo, United Technologies, Lockheed Martin, CSX, Johnson & Johnson, Medtronic, DaVita, Microsoft, Intel, IBM, Berkshire Hathaway, Home Depot, Disney, AT&T, Chevron, Conoco, and our other holdings—continue to strengthen their long-term enterprises independent of any short-term gyrations in their stock prices.

Following is a summary of business highlights from our portfolio companies during 2015, along with our expectations for 2016.

CONSUMER GROUP

While our primary consumer holdings—Coca-Cola and PepsiCo—continued to grow their global franchises during 2015, each of these entities reported lower per-share earnings due to a strengthening U.S. dollar. Principally, reported profits were lower due to translating large overseas sales into dollars. In addition, these consumer businesses are currently facing difficult economic conditions outside of the U.S. Nevertheless, we expect our consumer group to produce better results in 2016 as the current currency headwinds dissipate and the European economy recovers. We place these companies in the "invaluable" basket based on our belief that the increasing global consumption of their products will continue for decades to come.

Why are we sanguine about the long-term prospects of our global consumer franchises?

1. We have mentioned before the consistent purchase pattern among the product categories that creates an efficient long-term revenue and profit stream for these consumer franchises. You can imagine the daily consumption of Coca-Cola and PepsiCo products on a worldwide basis. Regardless of country, just about every person on earth will consume some non-alcoholic beverage today, including juice, water, tea, coffee, soda, and sport drinks. To illustrate the scope of our daily beverage consumption: More than 1.7 billion human beings around the globe consume an estimated 57 billion servings of non-water beverages. Coca-Cola and PepsiCo supply more than 2.25 billion (4%) of these "other than water" beverage servings, and their volume keeps growing at a steady pace. Although the total annual consumption of Coca-Cola and Pepsi beverage products equates to more than 100 servings per person on the planet, there is a lot more room for grabbing market share. It is our opinion that these big companies can become much larger in the future as gigantic emerging markets like China and India continue to develop their middle class!
2. Consistent purchase patterns and high product turnover allow these consumer franchises to effectively utilize assets. For a business that needs to invest vast sums of money into property, physical plant, and equipment to produce consumer goods, a steady unit sales pattern accompanying these assets leads to consistent production efficiency, maximizing the return on each dollar invested in the business. As a result, these businesses are able to produce high returns on deployed capital— and distribute a lot of cash to their owners— in both good and difficult economic times.
3. The art of making ingredients for Coca-Cola and Pepsi products (such as syrup concentrate) has not changed in decades—which means associated property, plant, and equipment last for years. During difficult economic times, these companies can "withhold" large capital expenditures. This is very important, as these businesses can continue to increase their penetration in growing parts of the world with minimal reinvestment, even as economies undergo temporary setbacks, such as today's economic conditions. Eventually, when good economic times return, these businesses are ready to invest further to capture the higher consumption rates that accompany an expanding global economy.

Businesses that do not share such attributes—for example, manufacturers of large appliances and automobiles—suffer under difficult economic environments as purchases for their large, expensive items decline precipitously. Because these extremely competitive businesses are more capital-intensive and experience slower and erratic product turnover, their returns on capital are also low. Consequently, they are usually not good long-term investments.

Coca-Cola and PepsiCo can be placed in the "invaluable" business category—enterprises that can grow far into the future and stand the test of time (both good and bad). Given their global distribution strength, product diversity, and cultural depth, we can forecast with a high degree of probability that Coca-Cola and PepsiCo will continue to demonstrate the same characteristics in the future that they do today. It is highly likely that each business will substantially penetrate developing markets over the next 10 to 30 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional financial models—in other words, each of these businesses possesses superior intrinsic value, underscored by their long-term value-creation potential.

Coca-Cola

The Coca-Cola Company maintains its status as a large holding in our portfolio, and one that we have held since Founders Capital Management was formed. We reiterate: We have no intention of selling (or cutting back) our position—and in fact, we will likely increase our holding over time. Although Founders is a relatively small holder of Coke's overall stock, we are nevertheless among the top 520 reported shareholders of this great company. Notice that we have moved up the shareholder ladder a few notches, from 575 last year, largely due to the company's ongoing share repurchase program – net share repurchases were around $2.25 billion in 2015. We point this out to display the hidden ownership impact of share repurchase programs.

This concealed increase in our share of the company's growing earnings was in jeopardy last year when the company announced a highly dilutive executive compensation program—resulting in our letter to Coca-Cola's board. As we reported, this issue was favorably resolved, and Coca-Cola announced a revision to its Equity Plan toward the end of 2014, stating that the company would provide employees fewer shares and stock options and shift to more cash-based performance awards in 2015. This was accomplished in 2015, and we are happy with the result.

During 2015, The Coca-Cola Company grew its overall case volume by approximately 2% (similar to 2014 and 2013). Case volume increases still remain slower than the annual 4%-5% annual growth achieved in previous years, and the company's revenue progression has been temporarily obstructed by a negative 7% currency headwind. As a result, revenue declined around 3.5% in 2015 to approximately $44.5 billion.

Aside from the currency impact, this year's sluggish advance was again impacted by several factors, including slower case volume growth in Eurasia and Africa (approximately +4% in 2015) and the Asia Pacific region (+3% in 2015). Despite recording slower overseas growth, North America's case volume grew approximately 2%, recovering from a flat year in 2014. Europe also displayed 3% growth in case volume, offsetting last year's volume decline of approximately 2%.

In summary, Coke's continued volume slowdown, combined with an unfavorable currency exchange, interfered with the company's 2015 earnings growth. The company will once again report $2.00 per share in adjusted earnings in 2015, on par with the past few years.

In spite of slower volume growth in the past several years, coupled with currency headwinds, we continue to believe that Coca-Cola's long-term growth prospects are intact for a few reasons:

1) Coca-Cola is in the midst of making core investments of $30 billion in various markets around the globe. The company is aggressively allocating capital to vastly populated areas such as China and India, which will support future annual volume growth that meets Coca-Cola's 4% to 5% targeted range.
2) The Coca-Cola Company has been implementing a productivity savings plan that will result in more than $3.0 billion of annual savings by 2019. This includes a sustainability goal to safely return 155 billion liters of water to communities and nature—an amount of water equal to what is currently used in Coca-Cola's finished beverages and their production.

3) Coca-Cola is making strategic investments to support the expansion of its currently 500 beverage products served in more than 200 countries. For example, the company has a 17% stake in Monster beverage, which positions Coca-Cola to participate in the fast-growing energy drink business.
4) The company is innovating new consumer delivery systems such as the Coca-Cola Freestyle machine, which allows consumers to dispense a mix of Coca-Cola product flavors into one drink, as well as a venture with Keurig Green Mountain to deliver Coca-Cola products directly to consumers at home through the new KeurigKold drink machine
5) Coca-Cola is strengthening its distribution system over the next five years to further expand its competitive advantage. The company is refranchising its company-owned bottling network, placing distribution territories in the hands of non-company-owned bottlers. This action frees up capital that would have otherwise been needed to bolster the capital-intensive bottling business and allows the company to create additional value—including distributing larger amounts of capital to shareholders through increased dividends and/or share repurchases.

In summary, we believe Coca-Cola is on track to take advantage of the two billion people around the world who will enter the middle class by 2020. We like the latest initiatives and think Coke is positioned to renew its volume growth in the near future, and further increase the company's intrinsic business value.

In the meantime, Coca-Cola will produce approximately $8.3 billion of cash for shareholders in 2015, and owner cash production will likely remain static in 2016 as the company continues to invest in future growth. Coke currently pays an annual dividend of $1.32 per share, which represents an approximately 3.1% yield, and we forecast that the company will increase its dividend 7.5% in 2016—to around $1.42 per share. It is our estimation that Coca-Cola will also repurchase approximately $3 billion of stock during the next 12 months. The combined dividend and stock repurchases provides shareholders an approximate 5% pass-through yield at Coke's year-end price, compared to a 2.27% yield on a 10-year U.S. Treasury Bond. Given the higher yield offered by Coca-Cola, as well as future growth projections, this company will remain a long-term holding in our portfolio.

PepsiCo

PepsiCo enjoys business attributes similar to Coke's—low capital intensity and enduring consumer brands that have consistent purchasing patterns—that make it a magnet for investors seeking an invaluable investment opportunity. As Coca-Cola's largest competitor in the beverage space, PepsiCo is duplicating Coke's commitment to investing in key emerging markets such as India and China. On the other hand, we have emphasized before that PepsiCo is not a mirror image of our Coca-Cola investment. PepsiCo is much more than a beverage company—it is a dominant snack-food company. Its mainstay global snack business, which represents more than 60% of the company's operating profits, has a *tenfold* relative global market share advantage compared to its closest competitor, with growth as far as the eye can see. Now that is an "invaluable" business franchise.

Over the past few years, PepsiCo's management team has taken steps to increase the intrinsic value of the business, including:

1. Renewing the company's investment in both the beverage and snack-food brands
2. Focusing on better capital allocation to core businesses that deliver higher returns

As a result of these actions, PepsiCo's margins and profitability are returning to pre- "poor capital allocation" days. As you may recall, in 2013 we were rather critical of PepsiCo's past capital allocation program and pointed out how important effective capital allocation was to a CEO's job. Others felt the same and pressured PepsiCo's management team to focus on reinvigorating its core snack-food and beverage brands, as opposed to allocating capital to new products that were entangled in an extremely competitive business that produced lower returns.

As a result of PepsiCo's concentrated efforts, the company's growth has resumed, and profit margins have begun to vastly improve, increasing the return on invested capital from approximately 16% in 2012 to more than 20% in 2015. (In short: This equation creates value.) It is our opinion that there is still a lot of hidden value within PepsiCo, as the company can make further strides with ongoing productivity gains (the new

annual savings target is $5 billion) as well as refranchising its beverage distribution system, similar to what Coke is undertaking. If these actions take place, PepsiCo's profit margins could increase an additional 25% over the next five years. This means profits and cash flows could exponentially increase over this time frame, and the return on invested capital could grow from the current 20% to more than 25% by 2020—producing more cash (and value) for shareholders.

In the meantime, PepsiCo continued to increase its return to shareholders, raising the annual dividend 7.25% in 2015, from $2.62 per share to $2.81 per share—this was on top of a 15% increase the prior year. We expect PepsiCo to raise its dividend to approximately $3.00 per share in 2016, which implies an approximate forward dividend yield of 3.0% at the year-end stock price. In addition, we anticipate that the company will repurchase an additional $4.5 billion of stock during the next 12 months. This action adds another 3.0% return to shareholders, reflecting a 6.0% pass-through yield. In 2016, we expect PepsiCo to earn around $4.85 per share.

In summary, we like the long-term potential and economics of the beverage and snacks business and think there is a multi-decade growth opportunity for dominant companies in these segments – earning these businesses a place in the "invaluable" basket. PepsiCo has a large position in these growing areas and will remain a long-term holding in our portfolio.

INDUSTRIAL GROUP

Our primary industrial and transportation holdings—CSX, United Technologies Corporation (UTC), and Lockheed Martin—represent "valuable" businesses that we believe will grow moderately over time. These businesses are somewhat capital-intensive, however, and sensitive to the economic cycle, which subjects them to setbacks during challenging economic conditions. This happened in 2015—the slowdown in the global economy negatively impacted our transportation and industrial group. As the European and Asian economies improve over the next 12 to 18 months, we expect these businesses to gain traction and produce better results in 2017 and beyond.

Our industrial group is largely represented by infrastructure businesses that are focused on product innovation and offer high-end products and services that are extremely expensive to produce and have a slow replacement rate—attributes that normally would be detrimental to a business' profitability. UTC and Lockheed Martin are exceptional in that these companies initially contract to sell their products at a low profit margin and then strike high profit-margin contracts to service the products over their lifespan. For example, when UTC installs elevators and air-conditioning units in skyscrapers around the world, the company also executes a long-term contract to service the equipment post-installation. Similarly, as Lockheed Martin constructs and delivers the F-35 fighter jet to military organizations around the globe, the sale of spare parts as well as high profit-margin servicing contracts associated with their delivery can continue for decades. In both cases, it is highly unlikely that these costly items will be replaced any time soon, providing a more predictable, long-term revenue annuity.

Our railroad investments have comparable advantages. It has taken more than a century to build the U.S. railroad infrastructure, and it would take an extraordinary amount of time and capital to create a business transportation system that competes with railroads such as CSX or Burlington Northern (owned by Berkshire Hathaway). Although the railroad business is capital-intensive, certain attributes make this type of investment attractive in either an inflationary or deflationary environment. In challenging economic conditions—due to either lower sales and decreasing prices in deflationary circumstances, or due to exponentially increasing costs in an inflationary environment—companies seek to run more efficiently. Moving greater amounts of goods over a fixed-rail infrastructure instead of via higher-cost trucking enables companies to lower costs and achieve large gains in productivity. Since rail transportation is approximately three to five times more fuel-efficient than truck transportation, it is likely that railroads will play an increasingly larger role in the transportation of goods throughout the U.S. in the future. The growing use of rail, along with the expansion of railroad services via "double track" (vs. single track) and "double stacking" of containers, will continue to drive a large increase in railroad use, revenues, and profits.

CSX Railroad

After a railroad investment hiatus of three years—we had owned Burlington Northern up until Berkshire Hathaway's acquisition of Burlington Northern Santa Fe (BNSF) in 2010—we invested in CSX railroad in early 2013. It took us a while to get back on track, as the relationship between price and value among rails failed to meet our test. We wanted a better bargain (discount to intrinsic business value) and had to be patient. When CSX's price finally hit our "strike zone," we backed up the railcars, so to speak.

CSX is one of the nation's oldest railroads and traces its roots back to the Baltimore & Ohio Railroad, which—when chartered in 1827—was the nation's first common carrier. The rail industry has undergone consolidation over the past 185 years, resulting in the 1980 merger of the Chessie System and Seaboard Coast Line Industries, forming what we know today as CSX.

As one of two major north/south railroads, CSX provides an important link to the transportation supply chain through its approximately 21,000 route miles of track that serves major population centers in 23 states east of the Mississippi River, the District of Columbia, and the Canadian provinces of Ontario and Quebec. The company is large, with more than 4,000 locomotives and 80,000 freight and container cars providing access to more than 70 ocean, river, and lake port terminals along the Atlantic and Gulf coasts, the Mississippi River, the Great Lakes, and the St. Lawrence Seaway. CSX also has an intermodal business that links customers to railroads via trucks and terminals.

During 2015, CSX generated approximately $12 billion in revenue—5% less than 2014, due to the economic slowdown. As a result of continued productivity improvements, however, CSX's operating earnings remained relatively flat, while per-share earnings actually increased 3% owing to the company's ongoing share repurchase program. CSX's share repurchase activity is also pushing us up the shareholder ladder—we are now among the top 210 reported shareholders of this great railroad (from number 225 at our initial purchase). Ultimately, we own a greater portion of the company's earnings today compared to three years ago. You can see why we are attracted to CSX.

Summarizing CSX's business activity during 2015:

1) The **merchandise business** ships approximately 2.85 million carloads (down 2% year-over-year) and generates 61% of revenue and 42% of volume. The company's merchandise business is the most diverse and transports aggregates (which includes crushed stone, sand, and gravel), metal, phosphate, fertilizer, food, consumer (manufactured goods and appliances), agricultural, automotive, paper, and chemical products. The lower year-over-year carloads were largely due to a decline in metals and fertilizer volume.

2) The **coal business** ships approximately 1.1 million carloads, accounting for nearly 21% of revenue and 16.5% of volume. Due to continued softening demand in this business, a year-over-year 10% decrease in coal volume was associated with a 13% decline in coal revenue. We expect coal volumes and pricing to stabilize in the next 18 months and to remain a strong category as the company continues to transport domestic coal to electricity-generating power plants, steel manufacturers, and industrial plants over a great part of the U.S.

3) The **intermodal business** accounts for approximately 15% of revenue and 41% of volume. Intermodal volume increased 4% year-over-year, as the importation and exportation of goods over rail continues to climb. The intermodal line of business combines the superior economics of rail transportation with the short-haul flexibility of trucks and offers a competitive cost advantage over long-haul trucking. Through a network of more than 50 terminals, the intermodal business serves all major markets east of the Mississippi and transports mainly manufactured consumer goods in containers, providing customers with truck-like service for longer shipments.

While CSX is heavily leveraged to the price of coal, it became less reliant on this business as other energy segments grew. For example, over the past few years, the ongoing decline in coal volume was offset with large gains in newfound oil and oil-related shipments within the U.S. As the American oil business boomed, oil companies drilled new wells in places ranging from Pennsylvania and Ohio in the northeast to Mississippi and Louisiana in the south. However, during the past year, the number of oil rigs used to drill new wells has decreased from more than 1,500 to around 525—a 65% reduction that parallels the decline in oil prices over

the past 18 months. It is no coincidence that low oil prices put a near-halt on new drilling, since it is difficult for most oil producers to make a profit at a per-barrel oil price that is less than $40. This decline in oil business is a double-whammy to a railroad company: CSX provides not only outbound transportation to companies that produce oil from shale oil wells, but also inbound transportation of drilling supplies (sand and chemicals) used to drill wells. We stated last year that the reduction in oil prices may slow drilling in 2015 and could negatively impact CSX's merchandise shipments in the short term. We were a bit off, as oil declined another 30% since our writing and never recovered. Over time, we expect the oil segment to recover as oil prices eventually increase—we just don't know when. Given that the U.S. has reemerged as a global oil producer, we believe that oil and oil-related shipments will positively develop over the long term—although not in a "straight line"—as America's oil production continues to rise.

We can see that CSX also has a tremendous growth opportunity in the intermodal business that offsets some of the anticipated slowdown in the merchandise business. We believe this business segment will continue to grow, because CSX's southern and southwest rail network is perfectly aligned with the upcoming Panama Canal expansion that is scheduled to open in April 2016. We mentioned last year that the Panama Canal was in the midst of building a third set of locks. This doubling of capacity will not only increase the throughput of the canal but will also accommodate significantly larger vessels. Currently, the Panama Canal is one of the most notorious bottlenecks in global trade, with a particular class of ship—the Panamax—designed specifically as the largest vessel that can fit through the canal's narrow locks. The expansion will change global freight movement by enabling container ships larger than the Panamax to pass through the canal. Previously, these larger ships could not reach the U.S. East Coast from Asia without a lengthy diversion around the tip of South America or through the Suez Canal. As a result, West Coast ports in the U.S. accept some 75% of Asian traffic, and this freight is sent on Class I railroads such as Union Pacific and Burlington Northern to reach the U.S. Midwest.

The Panama expansion will nearly triple the Panama Canal's capacity, increasing the maximum vessel size from 5,000 TEUs to 13,000 TEUs (a TEU, or 20-foot equivalent unit, is about the size of one intermodal container). This means that larger, more cost-effective vessels will be able to call on East Coast ports, allowing import freight to bypass the transcontinental trip on western U.S. railroads. Most ports on the U.S. East Coast are finalizing a build-out in anticipation of larger ships entering ports such as Houston, Charleston, Hampton Roads, and New York. It is expected that U.S. East Coast ports will capture 20%–35% of current West Coast volumes after the Panama Canal expansion is completed. This all bodes well for CSX, as its rail network is directly connected to U.S. East Coast ports.

Déjà Vu All Over Again!

In the past year, Canadian Pacific Railway—a large Canadian railroad—approached CSX about a merger. CSX rebuffed Canadian Pacific's approach, knowing that maintaining the company's independence would be more valuable to shareholders vs. a sale. Canadian Pacific scoffed at CSX's rebuke but still had an itch to acquire a railroad—thus, Canadian Pacific is in the midst of bidding for Norfolk Southern, CSX's largest competitor.

What do we think? We find it difficult to believe that the Surface Transportation Board—an independent adjudicating body housed within the U.S. Department of Transportation—would allow this merger to take place. If the merger were approved, competition would likely be lessened, leading to further mergers because larger rail companies would represent a threat to smaller counterparts such as CSX. It is likely that CSX would get caught up in the rail consolidation, and we would end up back where we started—happy with a premium price, but possibly taken out of a valuable franchise. We won't prognosticate, since CSX may come out as a winner in a merger. Nevertheless, we realize that bidding wars can lead to a loss of value for shareholders, and we are rather certain about our assessment of the current and future value of the CSX franchise we own. So stay tuned for the upcoming action—we will keep you up to date as the story unfolds!

In the meantime, during 2015, CSX passed $1.36 billion of cash over to shareholders in the form of dividends (around $685 million) and share repurchases (another $675 million). In 2016, we expect CSX to distribute an additional $1.36 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders an approximate 5.3% pass-through yield at CSX's year-end price, and we believe that this yield will grow over time as freight traffic increases over CSX's fixed-rail network.

In summary, we think our investment in CSX is an opportunity to participate in the continued growth of the U.S. economy. The growth in CSX's freight volume will endure over the upcoming decade and may increase a lot more than many analysts expect. Furthermore, CSX is executing a plan to lower the company's expenses and improve its operating ratio an additional five percentage points within the next four to five years. (The operating ratio is an important measurement in the railroad industry, representing the percentage of revenue used to operate the railroad—the lower, the better.) The projected increase in freight volume, coupled with lower expenses, will continue to leverage CSX's income and cash available for shareholders. We remain excited long-term owners of CSX, which occupies a very "valuable" position in our portfolio basket.

United Technologies

United Technologies Corporation (UTC) produces products such as Otis elevators, Carrier air conditioners, and Pratt & Whitney jet engines. Each one of the UTC's subsidiary companies has achieved leadership and powerful market entrenchment in its respective area of expertise. The company also has tremendous global reach in each of its business units, and their products are highly complementary. For example, the Midfield Terminal of Abu Dhabi International Airport—one of the largest airport construction projects in the world—will be completely equipped with Carrier air conditioners as well as Otis elevators and escalators by the time it opens in 2017. Otis will also supply 107 high-rise elevators and escalators for the Abu Dhabi Plaza in Kazakhstan, which will be the tallest building in central Asia—also slated for completion in 2017.

In addition to building and industrial systems, UTC is heavily involved in providing commercial and military applications, parts, and services. In the next five years, Pratt & Whitney will double engine production, and by the end of this decade will be producing engines at rates not seen since the early 1980s, when the company was a dominant jet engine producer. From large and small commercial jets to smaller business jets, Pratt & Whitney is delivering the next-generation engine that will power flight for years to come. The company is also the sole engine provider for the F-35 fighter jet—with more than 3,000 expected jet deliveries in the coming decades. To display the competitive moat around Pratt and Whitney, it is instructive to look at the company's investment cycle in the engine product line. On average, Pratt & Whitney loses around $1 million on each of its new engines that it is ramping up and actually expects to generate a loss of about $1 billion from new jet engine sales over the next four years. Although this is disheartening, the payback period on jet engines is very long and comes with solid returns, because Pratt & Whitney will enjoy a lucrative aftermarket revenue stream for the next 30+ years—this is where the money is. We can see that few competitors have the financial strength to undertake the significant up-front investments needed in this market. Pratt & Whiney estimates that its new engine technology requires about $10 billion in investment. Potential new entrants in the jet engine business would have to invest billions of dollars to build a better product, and years to obtain a reputation for safety and quality—all the while enduring significant initial losses, whether or not they were able to secure future orders.

These examples demonstrate UTC's business model: Focus on the installation of large infrastructure products, and then derive much of the company's future revenue from servicing agreements. Aftermarket services currently generate more than 40% of the company's $57 billion in revenues. In addition, these services are always in high demand because UTC's products are extremely expensive and are used in critical, heavy-wear applications (one cannot have elevators, security systems, building air-conditioning units, or jet engines failing).

UTC did have one development this year that is worth highlighting: The company sold its Sikorsky Aircraft division to Lockheed Martin for $9.0 billion. The helicopter segment was largely defense-related and carried lower profit margins than UTC's other businesses. UTC has been using the proceeds from the sale of Sikorsky to embark on an aggressive share repurchase program, buying back $10 billion of stock this year and targeting share repurchases that will total $16 billion through 2017. This strategy sounds counterintuitive, but our hope is that the stock price stays low over this time frame and the company eliminates nearly 20% of its shares at a significant discount to intrinsic business value—which would translate into an even greater share of future earnings for us. We are currently within the top 500 reported shareholders, and we look forward to climbing the UTC shareholder ladder over the next few years.

Although the slowing global economy has impacted UTC's businesses this past year, we remain optimistic given the cash annuity stream associated with long-term servicing agreements. Excluding the proceeds from the sale of Sikorsky Aircraft, the company is expected to produce approximately $5.60 per share in cash during

2015. When comparing the forward owner's cash stream of $6.00 per share to the company's year-end stock price of $96.00 per share, investors are receiving an initial 6.25% yield on their UTC investment—and we expect this per-share cash yield to grow over the next decade, especially with the current share repurchase plan. We are very patient and enthusiastic owners of UTC, and believe we are receiving a very good return on our ongoing investment in this very "valuable" company.

Lockheed Martin

Lockheed Martin is a 100-year-old, $45 billion global defense company. As you can imagine, the majority of Lockheed Martin's business is with the U.S. Department of Defense as well as U.S. federal government agencies.

Why are we investing in a business segment—defense—that is projected to decline in the future? Although the defense industry is likely to face budget reductions over the next 10 years, certain companies hold a strategic advantage in delivering "next-generation" defense products in the coming decades. For example, we stated previously that the U.S. military has contracted with Lockheed Martin to supply the F-35 fighter jet. The F-35 program is the largest defense project in the U.S., aimed at replacing the aging fleet of Air Force F-16, Navy F/A-18, and Marines AV-8B aircraft. This project is delivering more than 3,000 aircraft to eight countries around the world over the coming decades and is worth up to $1 trillion—encompassing $300 billion in new equipment and $700 billion in maintenance contracts. Large aftermarket sales should provide predictable ongoing earnings for Lockheed Martin, despite pressures on the U.S. defense budget.

During 2015, Lockheed Martin embarked on a realignment of its defense-related product portfolio. The company struck a deal with United Technologies Corporation (UTC) to purchase Sikorsky Aircraft, the world leader in military and commercial rotary aircraft (helicopters), for $9.0 billion in cash. The transaction closed in early November. It is interesting to note that the actual transaction price is effectively reduced to approximately $7.1 billion after taking into account tax benefits resulting from structuring the acquisition as an asset purchase. To offset the $9.0 cash purchase for Sikorsky, Lockheed is scheduled to divest its government information technology business. The sale of this business should exceed $4.0 billion and will likely be completed in the first half of 2016.

We are pleased with these transactions. Sikorsky is a natural fit for Lockheed Martin and complements Lockheed's broad portfolio of world-class aerospace and defense products—Sikorsky will likely do better under the umbrella of Lockheed's defense businesses as opposed to UTC's large commercial businesses. In addition, Sikorsky's Aircraft product line better complements Lockheed's defense portfolio compared to the government information technology business, which is better off in the hands of a company that is focused on the information technology sector.

Lockheed Martin produced approximately $11.35 per share in earnings during 2015 and distributed another $3.7 billion to shareholders through dividends and share buybacks. Lockheed Martin currently pays an annual dividend of $6.60 per share (up 10% from 2014), which represents a 3.0% yield at the company's year-end stock price. Lockheed's dividend, coupled with its ongoing share repurchases, provides shareholders a +6% pass-through yield at the company's year-end stock price. Although Lockheed had another healthy increase in stock price during 2015, the company's high pass-through yield still represents a better-than-fair return in today's low interest-rate environment. Until this equation changes, our plan is to remain invested in Lockheed Martin's "valuable" defense franchise.

HEALTHCARE GROUP

Our primary healthcare holdings—Johnson & Johnson, Medtronic, and DaVita Healthcare Partners—achieved profitable growth during 2015, and we expect these medical businesses to continue growing in 2016.

Over the past three years, the healthcare industry has been a lightning rod for government intervention, including uncertainties about healthcare reform legislation (i.e., the Affordable Care Act), as well as ongoing wrangling between government and industry parties over higher drug prices and their impact on increasing long-term healthcare costs.

Where do we stand on this? Our view is a pragmatic one: We believe in balance. The recent stories highlighting various drug companies that are price-gouging treatments for sick consumers are valid—and this activity is dead-wrong. On the other hand, we are at the precipice of delivering the greatest medical miracles in human history. New drugs will manage or eradicate debilitating diseases such as cancer, diabetes, and Alzheimer's disease and reduce human suffering. The cost of ongoing research and development needed to push these drugs forward is enormous, as is the cost of patient care for those inflicted with intractable diseases. In many cases, the high cost of curing these diseases is surpassed by the even-higher cost burden associated with chronic patient care.

We don't have the answers, but we understand the dilemma. Yet we cannot overlook the fact that the U.S.'s large fiscal imbalance is due, in part, to the significant growth in healthcare spending. The imbalance in this budget segment needs to be controlled in some fashion. Healthcare spending is still growing at a faster rate than the U.S. gross domestic product (GDP). According to the U.S. Department of Health and Human Services 2014 annual report, the steady climb in U.S. healthcare spending as a share of GDP approached 17.5%. What is interesting to note is the growing disparity in healthcare costs: While total U.S. spending on healthcare increased 5.3% last year— topping $3 trillion—healthcare funded by the federal government rose by 11.7%, to nearly $844 billion in 2014, compared to a 3.5% increase in 2013. Based on current projections and government healthcare funding, healthcare costs are projected to exceed 20% of U.S. GDP by 2023. We stated in previous letters that this situation is unsustainable and requires, among other measures, the long-term control of Medicare and Medicaid expenditures. (Medicare spending grew 5.5%, to a total of $618.7 billion in 2014, and accounted for 20% of total health expenditures; while Medicaid spending for the poor and disabled increased 18.4% in 2014, to $305 billion, compared with an increase of 6.1% in 2013.)

One way to rein in Medicare and Medicaid's cost growth is through government-controlled drug pricing—whether through increased regulation pressure on pharmaceutical companies, setting more restrictive reimbursement limits, or a combination of both. Either way, we believe this translates into lower profitability for the healthcare industry. (Conversely, if lower profitability is inevitable, then it is likely that greater government incentives will be needed to continue the necessary research and development to bring crucial drugs to market in the future.)

With all the changes occurring in the healthcare space due to the implementation of the Affordable Care Act, along with possible future alterations to healthcare, it has become increasingly difficult to predict the future of companies involved in drug development, medical devices, and other healthcare-related fields. Thus, all investors should exercise extra care when selecting companies in this sector. We believe that the uncertainty around the healthcare sector still provides an opportunity to own the "right" healthcare companies that do not carry many of the typical risks associated with this group. Johnson & Johnson, Medtronic, and DaVita HealthCare Partners are three companies that fit our long-term investment criteria: Each company occupies market niches that are fairly resilient under any economic condition or social reform, and each has consistent purchasing patterns and strong loyalty from a growing global customer base. It is our opinion that these companies are positioned to do well as the world population both increases and ages in the coming decades.

Johnson & Johnson

Johnson & Johnson (J&J) is a large healthcare organization with 265 operating companies located in 60 countries. It is also diverse, with sales generated by various healthcare segments—43% of sales from drugs, 37% from medical devices, and the remaining 20% from consumer brands that we are all familiar with: BAND-AID®, Tylenol®, Neutrogena®, Listerine®, and Johnson's® Baby Shampoo, to name a few.

Despite its large size, J&J maintains a decentralized organizational structure that allows each business to operate as an entrepreneurial company. The strength of a diverse organization can sometimes lead to complex management challenges—but under an entrepreneurial structure, each J&J business puts a heavy emphasis on growth. In addition, the company is focused on the patient and their core customer base (hospitals and physicians)— believing that their purpose is to deliver the best, most cost-effective healthcare to citizens around the globe. Shareholder returns are mentioned last in the "J&J Credo"—the company believes that it will be profitable as long as it pays attention to patients, healthcare professionals, employees, and the community first. This so-called value system has been wired into J&J's DNA since the company's founding.

J&J's unconventional approach of focusing on maintaining reasonable prices, supplying prompt service, allowing distributors and suppliers to make a fair profit, respecting the dignity of employees, and ethical management has made J&J an "invaluable" enterprise. Given the unprecedented aging rate of the world's population, coupled with a growing middle class around the world, we believe J&J has a tremendous future, and that it is difficult to place an exact value on this high-quality enterprise—we just know it's more. Over the past five years, even during economically and politically challenging times for healthcare companies, J&J increased sales by early 14% and profitability by 30%—from $13.3 billion to $17.3 billion.

During 2015, J&J will earn approximately $6.15 per share of adjusted earnings and should grow core earnings at 4% in 2016, to $6.40 per share (the strong U.S. dollar is also creating currency headwinds for this global company). The company generated around $17 billion of owner earnings in 2015 and returned a large portion of this cash to stockholders through continual share repurchases (approximately $6 billion) and $8.1 billion of dividends (a 2.9% dividend yield at the year-end stock price). J&J will remain a core position in our portfolio.

Medtronic

We also have a position in Medtronic, a therapeutic and diagnostic medical technology company with a global reach that extends to 150 countries. Medtronic is a different and more diverse company since the completion of its merger with Covidien in early 2015. Medtronic's portfolio of cardiovascular, spine, neuromodulation, and diabetes product lines are now joined with Covidien's surgical, vascular, respiratory, and patient-monitoring products. In addition, the company continues to develop its patient management business model and expand its position in areas that manage chronic diseases. The company's emphasis on disease prevention and management minimizes hospitalization, which is one of the largest contributors to rising healthcare costs.

The "new Medtronic" is now benefiting from unparalleled breadth across its product portfolio, and driving meaningful cost synergies since their combination with Covidien has been completed. In addition, last year we mentioned that the Covidien deal was tax-effective for Medtronic and that it would allow the company greater flexibility in deploying its cash. The deal was structured as a tax inversion, whereby the "new Medtronic" was redomiciled in Ireland and became Medtronic plc. As a result of "new Medtronic's" structure, the company made a recent decision to repatriate $9.3 billion in cash from overseas. This previously frozen money can now be utilized to further bolster the company's share repurchase program, as well as grow market share through supplementary investments in key markets.

During 2015, the new Medtronic generated slightly more than $28 billion in revenue. The company's approximate $6.2 billion of earnings are largely available for distribution to shareholders, representing a 5.7% look-through yield at the company's year-end price. Our expectation is that Medtronic will return money to shareholders in 2016 via a $1.52 per-share dividend ($2.14 billion) and will continue its stock repurchase plan, acquiring around $2.4 billion of stock over the next 12 months. Given Medtronic's current market strength in global healthcare, we will continue to hold this quality company in our portfolio over the long term.

DaVita HealthCare Partners

In early 2014, we made a large commitment to another healthcare company, purchasing DaVita HealthCare Partners. DaVita is one of the largest companies administering kidney care and dialysis services throughout the U.S. and also manages and operates medical groups, a network of primary care physicians, urgent care centers, and ambulatory surgery centers.

DaVita's kidney dialysis division represents 80% of the company's business and is one of the two largest dialysis providers in the U.S., along with Fresenius Medical Care AG & Co. DaVita's U.S. dialysis and related lab services businesses operate through a network of more than 2,225 outpatient dialysis centers throughout the U.S. that serve approximately 180,000 patients, representing an estimated 35% market share of the U.S.-based dialysis business. The company is also growing internationally, with 104 outpatient dialysis centers located in 10 countries outside of the U.S—up from 87 international locations last year.

The dialysis business is predictably steady due to a stable patient base, which we believe will continue based on a growing need for dialysis services. The U.S. dialysis patient population is expanding at a rate of approximately 4% annually and, given the aging population and increasing prevalence of diagnosed diabetes,

DaVita expects the growth rate to continue at 4% per year in the near future. In addition, since DaVita is on the forefront of developing relationships with referring physicians—as well as offering quality clinical care that will lead to reduced patient mortality rates—the company's size and broad patient service capabilities position it to grow further and to consolidate the industry through the acquisition of new dialysis centers.

DaVita also owns HealthCare partners (HCP). HCP is a patient- and physician-focused, integrated healthcare delivery and management company that has been providing coordinated, outcomes-based medical care in a cost-effective manner for nearly three decades. Through capitation contracts with some of the nation's leading health plans, HCP currently has around 840,000 members under its care in California, Arizona, Nevada, Florida, and New Mexico.

In summary, the stability of DaVita's dialysis business due to recurring revenues from ongoing patient visits contributes to strong margin performance and robust cash-flow generation. We expect that DaVita will continue to grow through both investments in new dialysis centers and modest-size acquisitions. The HCP business represents a tremendous growth opportunity for the future of this company as healthcare practices consolidate in the coming decade. HCP is one of the best physician practice platforms in the country, with a model that stands to benefit from the long-term shift that is under way in healthcare reimbursement from traditional fee-for-service to incentives for quality and cost control. Combining the steady growth and cash generation of the company's core dialysis business with the best physician practice management asset in the country, DaVita HealthCare Partners can be considered a very "valuable" franchise that is positioned at the forefront of a potentially long-term shift in healthcare delivery and reimbursement as healthcare reform is implemented.

In 2015, DaVita expected to finish the year with revenues exceeding $13.7 billion, up 7.5% year-over-year. Operating income of $1.9 billion in 2015 is up approximately 8% over 2014.

TECHNOLOGY GROUP

Of all the businesses represented in our portfolio, the information technology (IT) sector is still the toughest to call—business disruption occurs several times each decade and, therefore, industry participants and investors can never rest on past successes. During 2015, the technology sector continued to be in a complete state of flux as device miniaturization and cloud computing gained additional traction in the marketplace.

Given the inherent disorder and warp-speed change of the IT sector, it is very difficult to determine which companies will succeed or fail. Through new iPhone® and iPad® products, Apple continues to be a primary disrupter in the latest technology cycle, and further disruption is ahead as smaller, more powerful devices enter both the consumer and commercial markets. In addition, cloud services are growing exponentially in both consumer and commercial markets. For example, Amazon.com—a well-known retail industry disrupter— is also creating technology disruption with its cloud service business that is used by companies such as Netflix to store and stream content. Amazon's cloud service is now producing more than $8 billion of revenue. This growth is not going unnoticed, as existing as well as new entrants chase the growing cloud business opportunity.

Computer miniaturization and the emergence of the "big data era" are driving a new generation of products and services that empower every individual to stay connected, entertained, and informed, 24/7, via cloud computing. These technological advances have resulted in powerful computers that fit into the palm of one's hand or on one's wrist, the ability to track one's activity and fitness at every step and capture health data in "the cloud," and innumerable other capabilities. The associated new types of devices, high-speed connectivity, and fast-changing information services remain a challenge for old-fashioned computer companies such as Dell and Hewlett-Packard, which rely primarily on sales of older hardware devices such as PCs. The so-called "new space" companies competing in the manufacture of small, flexible devices that drive the new era of consumer technologies include Apple, Samsung, Facebook, Twitter, Amazon.com, Salesforce.com, IBM, Google, Cisco, Oracle, and Microsoft.

Which companies gain competitive control within the new IT ecosystem continues to be anyone's guess. But we remain committed to the belief that an investment opportunity exists, as investors toss aside certain "traditional" companies in favor of new emerging enterprises that are popularized by new technology and the

latest social media craze. The difference between price and value is growing rather wide with certain traditional technology companies that are maintaining a strong competitive position in the evolving technology landscape. Even so, we are unable to point to any one company in this industry that could be placed in the "invaluable" basket—there is too much churn, which makes it difficult to call.

We can, however, point to several computing companies that provide backbone infrastructure to support new information technologies that could emerge with a competitive advantage. Players in this space may not be as "consumer-centric" but will nonetheless play an increasingly important role in this rapidly changing industry. With this perspective, we are investing in what we believe to be undervalued technology companies that are providing core technology that all IT companies need. Our technology holdings that we would place in the "valuable" basket—Microsoft, IBM, and Intel—are well positioned to play a major role in the development of the new technology infrastructure.

Microsoft

During 2015, Microsoft remained the perfect example of how a company in the rapidly changing technology sector can adjust quickly and influence financial results. As you may recall, two years ago, technology experts described Microsoft as a "lost company" that remained out of touch with new technology that was overtaking the company's Windows franchise. These same pundits were predicting the eventual demise of Microsoft, labeling it the "last" technology company investors should own. Although we had not lost confidence with Microsoft over the long term and believed that it was still a valuable company that could adjust to the new technology environment, we became concerned with the growing uncertainty about Microsoft's market position when the company decided to purchase Nokia's phone business for $7.2 billion in late 2013. Thus, we made a decision to reduce our holding in Microsoft as the company's core products seemed less dependable and defendable, as well as less predictable and protected. Making matters worse, as the Windows franchise's market dominance seemed to erode, Microsoft was making a move toward consumer devices—a highly competitive arena that included Apple, Samsung, LG, and many others. Well, a lot has changed with Microsoft over the past 24 months. New leadership provided by Satya Nadella, who brought to the company a background in cloud and enterprise computing, put Microsoft back at the forefront of technology change. What shift within Microsoft has brought back the company's luster?

As a consumer revolution takes place in the technology area through device miniaturization, the portion of Microsoft's core Windows franchise that relies on older devices such as PCs is being replaced (and then some) by Microsoft's service offerings to large businesses, such as enterprise applications and cloud services.

We have previously discussed the emergence of cloud computing—the delivery of computing as a service instead of as a product. Using cloud computing, customers share resources, software, and information that are provided to personal computers and other devices as a metered service over the Internet. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged based on their usage. The infrastructure that supports cloud computing comprises large data centers (i.e., server farms) that are owned and operated by companies such as Microsoft, Google, IBM, Rackspace, and Amazon.com. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructure and decrease their reliance on corporate servers—resulting in overall savings in their IT spending budgets.

This is an area of the technology business that is very "sticky," because corporations are not as fickle as consumers, who change products at a heartbeat. While Microsoft is facing headwinds on the consumer side of its business that will continue to take time to work through, we continue to believe that the company may emerge as a dominant player in corporate computing. The "utilitization" of the enterprise cloud segment of the business is very attractive as well as highly profitable due to its long-term annuity-like attribute. Microsoft's fast-growing enterprise segment should account for approximately 57% of total revenue in 2016. The enterprise business is larger and extremely profitable (represented by an 80% gross margin) compared to the consumer business (a 46% gross margin). In addition, Microsoft's transition to cloud services continues to go smoothly, and Mr. Nadella has stated that cloud computing will remain a high priority for the company in 2016 and beyond. The stage is set for Microsoft—with its 100+ datacenters, containing more than 1 million servers—to be a major beneficiary of the growth in cloud computing.

Microsoft had very good business results in 2015, and we expect even better results in 2016. Microsoft's adjusted earnings are expected to be $2.89 per share in 2016, and may reach $3.43 per share in 2017—an annual growth of more than 14% for the next two years. During 2016, Microsoft will generate another $25 billion of owner earnings and will return approximately $25 billion of cash to stockholders through net share repurchases of $15 billion and around $10 billion of dividends (an approximate 5.6% pass-through yield at the year-end stock price). Given the consistent return of cash to owners of this company, Microsoft will remain a "valuable" long term technology position in our portfolio.

IBM

IBM remains one of the largest—and is one of the oldest—technology companies on earth. "Big Blue" has evolved through (and survived) many technology disruptions over the past century. We emphasize IBM's survival through past technology disruptions because it is once again facing a test to its business.

The advent of cloud computing is currently impacting IBM's old-line, direct-sale hardware and software businesses and, as with Microsoft, is now becoming a larger part of IBM's future. IBM is adjusting its direct hardware and software product lines to offer governments and corporations hybrid cloud services through more than 50 dedicated enterprise datacenters. IBM's government and large corporate enterprise cloud computing and service business is still nascent, however, and the company's loss of revenue and profitability from its previously mainstay direct-sale hardware and software businesses is not yet fully replaced by new revenue from the growing enterprise cloud segment. Due to this challenging transition, IBM remains out of favor with investors, and analysts are questioning the company's ability to successfully shift to a service-based technology company.

In addition, many analysts think the service-based technology segment is a "commodity type" business, with hundreds of competitors seeking to gain scale in this easy-entry area. We disagree, and think that enterprise cloud computing—as opposed to public cloud computing that many companies are focused on—is a different ballgame. No doubt, the cloud computing segment that is currently dominated by Amazon, Google, and perhaps Apple, is more heavily focused on the public consumer cloud service sector, as opposed to the private enterprise cloud business that Microsoft and IBM are focused on.

Given the seismic changes occurring in consumer computing, over the past few years IBM's business model has moved nearly 100% away from this segment. The company is now solely in the business of supplying large, complex organizations (such as corporations, governments, and municipalities) tailored technology solutions to meet logistical challenges. For example, in the local government sector, IBM assists cities in building hardware and software solutions to manage energy usage, as well as transportation logistics to efficiently manage traffic (including buses, subways, traffic lights, etc.). IBM's dominance in providing consulting and tailored technology solutions to the public sector and to private business segments is unique, worldwide, and slightly different from other technology organizations that offer "mass" computer solutions to mass-market consumers.

In summary: The disruption that cloud computing is creating in the technology industry is impacting IBM, and the company is going through a similar left-for-dead phase that engulfed Microsoft a few years ago. IBM's current low market capitalization reflects investor sentiment that the company will not successfully transition its business from providing direct-sale hardware and software solutions to providing tailored enterprise and cloud-based services to governments and corporations through massive data centers. We disagree, based on the fact that governments and large corporations tend to be "slow adopters" of new technologies such as enterprise cloud services, compared to their consumer counterpart. We believe that this will change, and this currently highly fragmented, networked infrastructure business segment will eventually "take off" and consolidate among a few dominant players. Why?

Taking a historic perspective: We can point to similar fragmented, capital-intensive, networked infrastructure industries that underwent tremendous disruption—all sharing similar attributes to today's enterprise cloud computing industry. Eventually, these industries were consolidated to just a few dominant players. For example, last year we cited the oil-refining business in the early part of the 20th century. This infrastructure industry was represented by an extremely fragmented network with hundreds of participants, only to be consolidated under John D. Rockefeller. Standard Oil became so dominant that the government eventually

decided to break up the company—Exxon and Chevron emerged as large parts of this breakup. The utility business is another infrastructure industry that naturally lends itself to consolidation, since survival in this business relies on large scalability and networking to maximize revenues and profitability. Plus, an abundance of capital is initially required to build facilities prior to taking in any money. Given the inherent business requirements of infrastructure industries, we can see that very few companies have the networking capability, staying power, and capital to compete—natural monopolies and/or oligopolies emerge, which is a primary reason the utility business is regulated.

Such industries require a strategy of scale and "control of the middle." Based on past experience with this business model, we think IBM (along with Microsoft) is positioned to emerge as a dominant player in the enterprise computing space. We believe the "utilitization" of computing will necessitate a tremendous network, as well as scale to maximize revenue and profitability—and this correlates with large capital expenditures to build server farms throughout the world. According to Forrester Research, global computing infrastructure is projected to be a $160 billion business by 2017, growing to a $240 billion business by 2020. This sizable infrastructure technology business requires tremendous up-front capital outlays, as well as extensive knowledge in computer networking that only a few firms will be able to provide in the pursuit of building a sustainable business that produces a future revenue and profit annuity stream.

Beyond Cloud Computing

Enterprise cloud computing by itself offers an infrastructure-based company such as IBM a tremendous future, but even more important is IBM's leadership in cognitive computing. With cloud computing, massive amounts of information (i.e., "Big Data") are housed on interconnected computers around the world. Cloud computing capabilities are especially robust in enterprise computing, where massive amounts of crucial government and corporate information are gathered and stored. Turning the massive warehouse of information into working knowledge has led to the emergence of cognitive computing—the simulation of human thought processes in computerized models—by which computers actually learn and, yes, even teach. Today's digital intelligence is based on data-gathering and analysis, but artificial intelligence is clearly on the horizon. Computer giants such as Google, Microsoft, and IBM are all working diligently to make advanced computer learning a reality. It is our opinion that IBM is the uncontested leader in developing learning computerization that will play a major role in our future.

We cited previously the book, *Smart Machines: IBM's Watson and the Era of Cognitive Computing,* by John Kelly III (Director of IBM's research). This book explains where and how IBM is approaching cognitive computing. In 2011, IBM's Watson computer (named after IBM's first CEO, Thomas Watson) famously beat two former grand champions on the TV game show, "Jeopardy." This was no small feat, as it took a team of about 20 IBM scientists five years of intense research to create a computer that could beat the smartest humans in a complex question-and-answer competition.

Last year, we reported that the IBM Watson Group had built a dedicated business unit headquartered in New York City that houses more than 1,000 employees devoted to cognitive computing. Recently, the company announced the opening of a new global headquarters and research lab in Munich, Germany for a division that will build Watson-based applications for Web-connected devices. This facility, as well as eight other planned global centers, are part of a $3 billion investment in cognitive computing by IBM. Each facility will focus on industries that are relevant to their home region. The Munich site will concentrate on automotive, industrial automation, and insurance markets, while planned hubs in Beijing and Sao Paulo could handle retail, consumer goods manufacturing, and pollution.

From working with physicians at Cleveland Clinic and Memorial Sloan-Kettering Cancer Center to diagnose diseases and assess the best "personalized medicine" treatments for patients, to helping African countries with ongoing challenges in healthcare, economics, and education, IBM's Watson Group is making the dream of cognitive computing a reality.

We think the opportunities in the cognitive computing field are boundless, and that IBM has a leading position in learning and executing this innovation. Despite questions about IBM's ability to transition seamlessly to a new era in computing, the company still demonstrates business consistency and earnings predictability. As a result, IBM distributed approximately $10 billion to shareholders during 2015 through $5 billion of dividends and $5 billion of stock repurchases. This represents an approximate 7.5% pass-through yield at the year-end

stock price. We remain enthusiastic with IBM's current returns to shareholders, and excited about the long-term prospects for this "valuable" company.

Intel

Intel is a large technology company that designs, manufactures, and sells computer components and related products. The company's major lines include microprocessors, chipsets, flash memory and graphics products, and network and communications products. Intel holds a dominant market share for microprocessors that are used in desktop and laptop computers as well as computer servers. This was not always the case, however, and Intel's history is worth reviewing to highlight the company's ability to navigate a changing technology industry.

At its founding, Intel was distinguished by its ability to make semiconductors. Intel's business grew during the 1970s as it expanded and became adept at high-end, efficient manufacturing processes. Intel's manufacturing excellence allowed the company to produce a wider range of semiconductor products than competitors, giving the company an opportunity to control the market. In the early 1980s, Intel's business was dominated by dynamic random-access memory (DRAM) chips—a device that stores each bit of data in a separate capacitor within an integrated circuit. This is a commodity product focused on memory in the world of computing and is subject to tremendous competition. By 1983, low-cost Japanese semiconductor manufacturers had entered the DRAM business and dramatically reduced the profitability of this market.

At the same time that competition became fierce in the commodity DRAM market, a tremendous disruption began as personal computing took hold—PC usage was growing exponentially among consumers. The rising success of the IBM personal computer, based on an Intel microprocessor, became the inflection point for Intel. Gordon Moore, Intel's CEO at the time, was convinced that high-end microprocessors were the future, and he "bet the company" on a business model shift, leaving the memory market to gain an unmatched competitive advantage in the new microprocessor space. This business model shift worked, and Intel has enjoyed a dominant position in providing microprocessors to the PC market over the past few decades.

Nevertheless, technology disruption is here once again, as consumers rapidly move from Intel's mainstay microprocessors located in desktop and laptop computers to smaller mobile devices. In addition, large data centers have become more prevalent to support cloud computing, lessening an individual's need for a more sophisticated PC. As a result of this quick shift in technology usage, legacy PC sales have slowed and are now in decline—and thus, Intel is facing a challenging period. It is now once again necessary for Intel to adjust its business model to meet the growing demand for mobile and cloud computing products—areas in which Intel has had a minor presence.

So, why have we accumulated a position in Intel, a company that is undergoing a disruptive period that creates business uncertainty?

We continue to believe that Intel's transition to the mobile segment will take some time, but that the company will establish a successful presence in the computing market of the future based on several factors:

- **Intel's microprocessors form the backbone of the Internet and cloud-based computing.** According to Data Center Map, approximately 3,770 co-located datacenters in 112 countries make up what we can call the "global computing platform." These datacenters collectively contain more than 60 million computer servers, most of which are running on Intel products. Although this is a large number, the amount of computer servers needed to manage the growth of global computing is expected to double by 2021—and Intel is at the forefront of providing technology to help operate this network efficiently.

  In addition, in December 2015, Intel completed its $16.7 billion acquisition of Altera, developing a new division called the Programmable Solutions Group. Altera's product line of programmable solutions makes Intel the second-largest maker of chips that can be programmed after they leave the factory. Altera's chips are used in an array of devices that include networking equipment, a field that Intel has recently targeted. The programmable chips are increasingly used in computer servers that make up a growing share of cloud computing and complement Intel's existing powerful chips in this market segment. In a different setting, Intel can integrate its Atom chips with Altera's programmable solutions to participate in new sectors such

as automobile electronic systems, where the ability to reprogram chips could bring new features to vehicles even after they have been sold to consumers.

- **Intel is transforming and broadening its scope** from a primary focus on designing and manufacturing microprocessors for PCs and servers to include delivery of multiple hardware and software platform solutions. As the number and variety of devices connected to the Internet grows, and computing becomes an even more interactive experience, customers will increasingly want their devices to connect seamlessly and effortlessly to the Internet and to each other. In 2015, Intel introduced its 6th-generation core processor that increases productivity and battery life among computing devices.

In summary, Intel is managing the current technology disruption well, and the company is positioning itself for the next generation of computing. We believe Intel will play an important role in the utilization of computing and will obtain a terrific revenue and profit annuity in future years through its multi-product offering in high-end computerization.

Intel will earn approximately $2.23 per share in 2015 and is projected to grow more than 6% in 2015, to $2.37 per share. We expect the company to continue its growth in 2017 as it further penetrates the cloud computing sector and works toward developing a profitable foothold in new business segments such as the mobile space. In the meantime, the company will generate approximately $10 billion of owner earnings and will return this cash to shareholders through dividends of $4.5 billion and share repurchases of $5.5 billion, respectively—Intel's dividend yield is 2.8% at the year-end stock price, and the pass-through yield exceeds 6% when including share repurchases. We still consider Intel a "valuable" company, and a good investment given the current return to owners, along with an optimistic future.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Berkshire Hathaway is our largest financial services holding as well as our largest overall position. Berkshire Hathaway experienced an approximate 5% growth in book value during 2015, a slowdown from the 8.3% increase in 2014 and 18% increase in 2013. This year's book value growth has been impacted by temporarily poorly performing equity positions in Berkshire's equity portfolio—large positions in Wells Fargo, IBM, American Express, and Coca-Cola were collectively down around 5.5%. In addition, a slowdown in economically sensitive, wholly owned industrial companies impacted Berkshire's earnings growth. Nevertheless, Berkshire's intrinsic value grew more than book value in 2015, and we are enthused about the long-term gains in Berkshire's shareholder worth.

Since the 2008 financial crisis, Berkshire's annual per-share book value has grown approximately 12% (book value growth provides an indication of Berkshire's value creation but is not a perfect correlation). We are very pleased with this result, as Warren Buffett keeps adding value with each incremental step he takes at Berkshire. It still amazes us to watch Mr. Buffett step into the batter's box and hit one home run after another. And in 2015, we believe Mr. Buffett once again hit several pitches out of the park that create future intrinsic value that is not currently reflected in Berkshire's book value.

Berkshire Deals in 2015

In the first quarter of 2015, Berkshire Hathaway finalized the acquisition of Van Tuyl Group, the nation's largest privately owned auto dealership group, with 81 locations in 10 states. Van Tuyl Group ranks fifth among all U.S. auto dealership groups. After becoming a part of the Berkshire Hathaway family of businesses, the company is now known as Berkshire Hathaway Automotive. This multibillion-dollar acquisition gives Berkshire Hathaway an opportunity to create shareholder value through further concentration of the nation's automobile distribution system. There are more than 17,500 new-car dealerships in the U.S. and, given the increasing complexity and capital requirements associated with the automobile distribution business, it is highly likely that consolidation will continue during the next decade. The combination of Berkshire's deep pockets with Van Tuyl's management expertise will create a unique competitive advantage for Berkshire's new automotive group.

You may recall that in June, 2013, Berkshire and an affiliate of the global investment firm, 3G Capital, acquired H.J. Heinz Company through an equity investment each made in the holding company, Heinz Holding. Heinz is one of the world's leading marketers and producers of healthy, convenient, and affordable foods specializing in ketchup, sauces, meals, soups, snacks, and infant nutrition. Heinz brands include Heinz® Ketchup and Ore-Ida® potato products.

Just shy of two years later—in March 2015—Heinz Holding (co-owned by Berkshire and 3G) and Kraft Foods Group entered into a merger agreement under which Kraft shareholders were entitled to receive one share of newly issued Heinz Holding common stock for each share of Kraft common stock and a special cash dividend of $16.50 per share. Kraft is one of North America's largest consumer packaged food and beverage companies, with annual revenues of more than $18 billion. The company's iconic brands include Kraft®, Capri Sun®, Jell-O®, Kool-Aid®, Lunchables®, Maxwell House®, Oscar Mayer™, Philadelphia®, Planters®, and Velveeta®.

The merger transaction closed on July 2, 2015, at which time Heinz Holding was renamed The Kraft Heinz Company. Kraft Heinz issued approximately 593 million new shares of its common stock to the former Kraft shareholders and, following the issuance of these additional shares, Berkshire and 3G owned approximately 51% of the outstanding Kraft Heinz common stock. (Berkshire owns approximately 26.8%, and 3G owns 24.2%.) Under current accounting rules—the equity method of accounting—the issuance of shares by an investee is accounted for by the investor as if the investor had sold a proportionate share of its investment. Thus, as a result of this transaction, Berkshire recorded a non-cash pre-tax holding gain of approximately $6.8 billion in the third quarter of 2015. The bottom line: This recorded gain reflects the tremendous return Berkshire achieved on its initial investment in Heinz Holding common stock over a short period of time—we like that.

In August 2015, Berkshire entered into a definitive agreement to acquire Precision Castparts Corp. for $235 per share of common stock in cash, representing an aggregate consideration of approximately $31.7 billion. Precision Castparts is a global, diversified company that is a market leader in manufacturing complex structural investment castings and forged components for aerospace markets; machined airframe components; highly engineered, critical fasteners for aerospace applications; and airfoil castings for the aerospace and industrial gas turbine markets. Precision Castparts is also a leading producer of titanium and nickel superalloy melted and mill products for the aerospace, chemical processing, oil and gas, and pollution-control industries and manufactures extruded seamless pipe, fittings, and forgings for power generation and oil and gas applications. We believe this acquisition—one of Berkshire's largest to date—will add intrinsic business value to the overall entity for years to come.

Berkshire keeps growing and effectively allocating capital that is creating greater intrinsic value for shareholders. Berkshire continues to build its financial muscle, producing long-term value from a well-established financial business that consistently generates a low cost of borrowed customer funds (less than zero). The float produced by Berkshire's insurance subsidiaries "sticks" within the company for many years—i.e., Berkshire gets to maintain premiums paid by insurance customers for years prior to paying out claims. Berkshire primarily generates its float by providing insurance directly to individuals (GEICO) as well as by providing other insurance companies coverage against very large catastrophic-loss events, such as hurricanes and earthquakes (this is called "reinsurance").

With the long length of time Berkshire holds customer funds, the company receives the benefit of investing float with a long-term horizon—to obtain a highly probable rate of return on this money. The funds are invested in understandable assets and, in many cases, in wholly owned businesses that will remain a part of Berkshire indefinitely. As we can see by Berkshire's activity in 2015, this equation has not changed, and we do not expect this equation to change in the future.

In summary, Berkshire's business model pivots on making investments in and/or buying good companies at attractive valuations with low-cost insurance funding. Mr. Buffett is continually buying businesses that generate very high levels of cash flow that accumulates over time—and then effectively reallocating this cash to ever-increasing opportunities. Mr. Buffett, and his money management team, clearly demonstrate the art of value(able) investing, picking up $1 of today's value for the price of 65¢. We remain enthusiastic owners of this valuable company, and we look forward to Warren Buffett's future allocation decisions as capital quickly accumulates on Berkshire's balance sheet.

Fairfax Financial Holdings

Our second-largest financial services investment is Fairfax Financial Holdings. Chairman and Chief Executive Officer Prem Watsa continues to build Fairfax's insurance and reinsurance business in a fashion similar to how Warren Buffett built Berkshire. Fairfax operates on a decentralized basis, with each Fairfax subsidiary insurance company providing a range insurance products. Fairfax also strives to maintain a diversified portfolio of risk across all classes of business, geographic regions, and types of insureds. Most important, autonomous management teams are focused on underwriting profitably in their respective markets.

Since the company's founding in 1985, Fairfax Financial Holdings' per-share book value has grown at a compounded rate of 20+% per year. During 2015, Fairfax's per-share book value grew approximately 2.5%, a slowdown from the 16.5% gain the previous year. We have emphasized before that Fairfax's annual results can be very "lumpy." This is largely due to embedded returns on investments that are not reflected for several years through the company's income statement and balance sheet. We are more than happy to be patient as long as we understand the activity taking place at Fairfax through the company's disciplined accumulation of low-cost float, the ability to have float stick within the company for a long period of time, and management's ability to allocate capital in a favorable manner for shareholders. Fairfax currently has all three legs of the successful insurance company stool, and we are excited about its future prospects.

During the past year, Fairfax continued to grow its insurance business organically as well as through opportunistic acquisitions. On January 30, 2015 the company, through its subsidiaries, acquired 30,000,000 multiple voting shares of newly incorporated Fairfax India for $300 million through a private placement. Through that investment and offerings of subordinate voting shares, Fairfax India raised net proceeds of $1.025 billion after issuance costs and expenses. The company's multiple voting shares represented 95.1% of the voting rights and 28.1% of the equity interest in Fairfax India at the close of the offerings.

Fairfax India was established, with the support of Fairfax, to invest in public and private equity securities and debt instruments in India and Indian businesses or other businesses primarily conducted in or dependent on India. The company then expanded its interests in India through an open offer to acquire up to 26% of the outstanding equity shares of IIFL Holdings Limited, formerly India Infoline Limited, for an aggregate cash consideration of approximately $250 million. In addition, during the third quarter of 2015, Fairfax India completed the acquisition of National Collateral Management Services Limited by acquiring a 73.6% interest on August 19, 2015 and a further 14.5% interest by September 28, 2015 for purchase consideration of $124.2 and $24.5, respectively. We can see that Fairfax is establishing a large presence in India, a fast-growing market that will reward shareholders over time.

In the third quarter of 2015, Fairfax completed the acquisition of 100% of the outstanding ordinary shares of Brit PLC for an aggregate cash consideration of $1.7 billion. Brit is a market-leading global Lloyd's of London specialty insurer and reinsurer. In order to minimize the capital constraints on Fairfax from this acquisition, the company completed the sale of 29.9% of the outstanding ordinary shares of Brit to Ontario Municipal Employees Retirement System ("OMERS"), the pension plan manager for government employees in the province of Ontario, for cash proceeds of $516 million. As part of this arrangement, Fairfax will have the ability to repurchase the shares owned by OMERS over time.

These acquisitions fit Fairfax's goal—to gain full control and accumulate low-cost float that will stay within the company for a long period of time. The "long tail float" (in insurance parlance) that results from Fairfax holding customer premiums for a greater length of time allows Mr. Watsa and his team the opportunity to invest low-cost borrowed funds over a lengthier time horizon. In layman's terms, Fairfax is now borrowing approximately $18 billion (up 15% from year-end 2014) of customer funds at a low cost, and holding these funds for a greater length of time—providing the company even greater long-term investment flexibility. This equation further increased the company's intrinsic business value in 2015, despite the stock price not following in lockstep. We still think of Fairfax as a "baby Berkshire."

On the money-generating side of the equation, Fairfax invests its float in understandable assets, including non-insurance companies that Fairfax is purchasing outright. While there are some cases in which Fairfax has made investments that are "not so understandable" to non-financially oriented individuals, we believe we understand these more esoteric investments and are comfortable with the capital allocation by Mr. Watsa and his team. To

give you comfort, we will continue providing past examples of what we consider to be Fairfax's esoteric investment activity.

Prior to the financial crisis of 2008, Fairfax had taken derivative and swap positions to protect the company's net worth in case of a sudden market downturn—these positions worked out well for the company during the financial debacle. Given the robust market recovery over the past seven years, along with the still-fragile global financial system, Mr. Watsa and his team have implemented a similar strategy to protect the company's net worth in case of sudden market turmoil. In addition, Fairfax continues to execute an inexpensive insurance transaction that provides a good example of the company's investment prowess. Mr. Watsa and his team purchased something called "CPI-linked derivatives"—contracts that protect the company from deflation that may possibly occur in the European Union, U.S., United Kingdom, and France. These contracts specify that, in the event of annual cumulative deflation occurring over a weighted average period of approximately seven years, Fairfax would be protected from the adverse financial impact of decreasing pricing levels. This is an important concept to consider, given that the company is undergoing overall underwriting results whereby Fairfax is paying policyholders throughout the world approximately the same as the premiums received. In a deflationary environment, you also do not want a scenario in which your liabilities stay the same or increase while the value of your assets deteriorates significantly—this is a dreadful equation.

Fairfax has purchased protection against deflation, with the notional contract value representing approximately $109 billion. These CPI-linked derivative contracts are extremely sensitive and are valued via "cumulative deflation"—meaning that for every 1% in cumulative deflation, Fairfax will receive 1% of the notional amount of the derivative contracts. For example: If, on average, the EU, U.S., U.K., and France experience just 1% of cumulative deflation over the contract period, Fairfax will receive around $1.1 billion on the $109 billion of notional contract value.

We think Fairfax Financial Holdings is a "valuable" company that remains a good investment during difficult financial times and that the company continues to build significant value for shareholders, while at the same time covering its downside risk. We remain excited about our long-term opportunities with Fairfax.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens Boots Alliance—had another great year in 2015, with retail purchases growing at both specialty businesses. Year-over-year, same-store sales increased once again by around 5% for both companies, and growth in same-store sales for both specialty retailers exceeded growth in GDP. The expanding intrinsic business value created by Home Depot and Walgreens Boots Alliance can be directly attributed to these organizations' understanding of the four essential elements to retail success:

1. **Excellent customer service:** If individuals walk into your store and get a whiff of poor customer service, they will likely turn around and shop elsewhere. Customer service is paramount in the retail business, and not something any retailer can compromise on.
2. **Product selection and superiority:** A retailer must constantly ensure that it is offering the right selection of products at the best possible price. You can provide a great service to your customer with attentive associates and a wonderful retail atmosphere, and then deliver a disservice by stocking the right products at the wrong price, the wrong products at the right price, or, worse yet—the wrong products at the wrong price.
3. **Value creation:** It is tough—perhaps very tough—to make money in retail. A robust understanding of product turnover, day-to-day revenue and expense management, and long-term capital allocation decisions all play into successful value creation.
4. **How to blend one's so-called "bricks and mortar" offering with the new "online channel:"** Interconnected retail continues to be a growing dimension in this industry. Successfully integrating the in-store and online customer experience is essential to creating customer and company value.

It is clear that retailing has many moving variables that require tending each and every day. Inattention to any of these details can lead to difficulty—Sears, JCPenney, and Staples are all facing challenges in one or more of these areas, with corresponding sales and profitability challenges.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—Home Depot and Walgreens Boots Alliance continue to fit this description. These retailers are adding value as their specialty segments continue to undergo consolidation and small competitors fall by the wayside, a dynamic that has accelerated during these challenging economic times. The retail areas in which we are invested focus on a couple of two-horse races—between Home Depot and Lowe's in the home improvement market, and between Walgreens Boots Alliance and CVS in the retail pharmacy market. All four are continuing to gain ground in the difficult retail space and will likely gain further ground in upcoming years. We have not changed our view: Our retail enterprises can be placed in the "very valuable" business basket as it is virtually impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate development.

Home Depot

Home Depot had another off-the-charts year, with same-store sales increasing another 5% and gross margins remaining above 34%—higher sales coupled with a high profit margin in this space leads to maximizing shareholder value. Housing continued its recovery, with the FHFA housing index increasing around 6% during the last 12 months. What is more interesting is that home improvement sales as a percent of all retail sales has risen to approximately 8% but remains below the long-term average of 8.7%. Given these facts, Home Depot is thriving and can continue to prosper as the company continues to focus intensely on providing the best of the four "great retailer" legs.

In our past letters, we mentioned Home Depot's initiatives, such as "Customer First" (to raise customer satisfaction) and "Localization" (to create a product assortment that is tailored to each local market). These two programs, fixated on enhancing customer service and providing greater product selection targeted to specific customers, created an environment for Home Depot to thrive once again in 2015.

Home Depot is now embarking on new initiatives to further grow the company and create value for customers and shareholders. In July 2015, Home Depot acquired Interline Brands for $1.6 billion. Interline Brands, located in Jacksonville, Florida, is one of the largest wholesale distributors of maintenance, repair, and operations products for non-industrial businesses in the U.S.. The company distributes a broad range of products such as electrical, janitorial, plumbing, and security supplies to property managers and institutions such as hospitals.

Home Depot's strategy in acquiring Interline Brands is to create a one-stop shop for Interline's customers by offering adjacent products that are normally sold through Interline's salesforce—for example, selling flooring, countertops, and other core Home Depot products to property managers and institutions that Interline services. The addition of Interline provides Home Depot an established platform (i.e., sales force, product assortment, distribution assets) that is focused on the maintenance, repair, and operations business segment where Home Depot doesn't compete.

Home Depot's supply chain management and technology improvements continue with the company's efforts to own "the last mile." This initiative takes efficiency to the next level as the company enhances its ability to directly deliver goods from local stores to customers that order online. The new "buy online deliver from store" program further improves inventory turn and lowers fulfillment costs and in-stock inventory by approximately $3.8 billion. To accomplish this initiative, in 2015, Home Depot established its third direct fulfillment center. As a result, Home Depot can ship directly to 90% of its customers within two business days.

In addition, the direct delivery program is targeting professional construction customers with a two- or four-hour delivery window for a fee. Home Depot is also rolling out SYNC, which is an initiative aimed at synchronizing the flow of product from supplier to shelf. This endeavor will optimize lead times to potentially five days, improving on the current 11-day lead time average.

These initiatives are expected to further drive Home Depot's sales and profitability over the next three years. We expect Home Depot to earn approximately $6.10 per share in calendar 2016 and to increase earnings 10% in calendar 2017—to $6.70 per share. As a result of staying focused on the four-legged stool of retail success, Home Depot continues to produce significant amounts of cash that is being distributed to shareholders. This valuable company will generate nearly $9 billion of owner earnings in 2016 and will return this cash to stockholders through share repurchases of approximately $6 billion and $3 billion of dividends (a 5.3% pass-

through yield at the year-end stock price). We remain pleased with the company's ongoing focus on customers and shareholders, and we plan to remain long-term owners of this "valuable," one-of-a-kind retailer.

Walgreens Boots Alliance

Walgreens Boots Alliance is a "valuable" retail firm that is focused on the healthcare segment—and is gaining strength as the company emphasizes domestic and global expansion. In 2015, Walgreens executed on its plans to officially become a global entity through its second-stage acquisition of Alliance Boots, the leading pharmacy-led health and beauty group in Europe. The combined organization has taken shape as Walgreens Boots Alliance. A new management team under the leadership of Stefano Pessina is successfully integrating and transforming the traditional drugstore and creating a company platform for selling and distributing healthcare products to more than one billion people through 13,100 stores and more than 350 wholesale distribution centers located around the globe. What emerges from this healthcare combination is an integrated, global drug distribution platform that is unmatched—providing Walgreens Boots Alliance the "first mover global advantage." The combined company is one of the largest purchasers of prescription drugs in the world, giving it more leverage in negotiating with drug suppliers to lower costs on the annual purchase of hundreds of millions of prescriptions.

Adding even more growth: In October 2015, Walgreens Boots Alliance announced the acquisition of Rite Aid Pharmacy in the U.S. for $17.2 billion, including debt. The $9.4 billion paid to Rite Aid equity holders will be completed via a cash payment from Walgreens Boots Alliance, which eliminates dilution to current Walgreens Boots Alliance shareholders—this is very important to us. After the acquisition is completed in 2016, Walgreens will become the undisputed leader in retail pharmacy products in the U.S. through a combination of Rite Aid—the third-largest drugstore chain in the U.S., with 4,561 stores in 31 states—and Walgreens' current U.S. store base of 8,050 locations.

We are looking for further increased value as Walgreens Boots Alliance takes advantage of industry consolidation while maximizing productivity efficiencies and emphasizing unmatched customer and patient healthcare services. The combined global entity will continue to expand product selection at affordable prices, and interconnect the global in-store and online retail experience to create a specialty healthcare business that is different and unmatchable. We believe that the Walgreens Boots Alliance of the future is shaping up to be much more than a typical retail pharmacy. The company's planned evolution to offer global consumers a more integrated package of healthcare services will create significant value for shareholders.

In the meantime, Walgreens Boots Alliance produced positive results in 2015, with same-store sales growing by approximately 6%. The company earned adjusted earnings of $3.88 per share in its fiscal year-end, August 2015, and should grow earnings at approximately 13.5% in fiscal 2016, to $4.40 per share. We continue to be excited owners of this "valuable" global franchise and expect terrific results in the future.

MEDIA GROUP

The media and communications business continues to be a challenging investment area—this industry is extremely competitive and dynamic due to its reliance on changing technology infrastructure (internet, cable, etc.). Due to the vast number of channels available for content distribution and the multiple mediums through which consumers can access entertainment, it is paramount that media companies create and distribute "great content" to attract customers and advertisers. We know of no other business in which a customer or advertiser can switch loyalty as quickly as in the media business. And a switch in advertising revenues is happening at a rapid pace due to the disruption in this industry. As a result, several legacy content providers that rely on advertising revenues to drive profitability experienced a decline in stock price between 25% and 40% over the past 12 months. We can see that it is important to choose media companies that have a special grip on the marketplace by producing tremendous content that attracts various advertisers despite the disruption created by services such as Netflix and Amazon Prime. In this category, we continue to hold what we consider to be the best media business in the industry: Disney.

Walt Disney Company

Disney is a one-of-a-kind media company that we have placed in the "best-of-the-best" category due to its "invaluable" franchise. The invaluable nature of Disney is based on its unmatched content (films, characters, etc.) that is analogous to an oil well that keeps producing indefinitely after the initial development expense. Each time the company develops an animated or iconic film, much of the film development is expensed at the time of its introduction. In future years, when the company re-launches these classic films in updated formats (DVD, 3D, etc.), Disney attains additional revenues and profits without incurring the original expense of developing an animated film. We refer to these re-launches from the company's film library as "accessing the Disney vault." That the content of this vault consists of gooses rather than golden eggs is an important investment point—the magic gooses keep laying golden eggs—e.g., *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians, Frozen, Inside Out and The Good Dinosaur.* We can envision our grandchildren's grandchildren watching many of these classic Disney films in the new millennium, no matter what future medium the content is delivered on. The value of the Disney vault is incalculable because of the 100-year annuity associated with placing new iconic films in this facility, as well as reissuing previous Disney films as novel delivery mediums emerge and new generations of children are born—globally.

Every decade or so, a great franchise comes under exceptional leadership—and this is the current case with Disney. Disney's current CEO, Bob Iger, and his management team have done a remarkable job creating shareholder value. Mr. Iger has maintained the company's culture and focus while expanding Disney's invaluable library of content, broadening its distribution network, and embracing new technologies that complement and enhance the Disney experience. In addition, under his leadership, new film franchises (i.e., golden gooses) are being added to the Disney vault through the company's unmatched creative team—in both animated and unanimated film. The latest value-enhancing installment to the Disney franchise was LucasFilms, the makers of the Star Wars series, which Disney purchased for $4 billion in December 2012. After three years, LucasFilm's first Star Wars film under Disney—*Star Wars: Episode VII*—was introduced in December 2015. This film is on track to be the biggest blockbuster of all time, having produced $600 million in ticket sales in the U.S. during its first 12 days. By December 27, *Star Wars: Episode VII* had global box office receipts that exceeded $1.0 billion—the fastest film to reach $1.0 billion in sales after its release in history. The better news: As part of the new Star Wars trilogy, Disney is introducing two more franchise films in the next six years. In addition, several Star Wars spin-off films are in the works to add to this developing franchise. This is a great example of how Disney is creating incremental value for shareholders.

Mr. Iger has committed to staying in the leadership position at Disney through 2018. We are very confident in Disney's management team and believe that Disney has stronger long-term growth prospects than most investors realize due to the company's highly competitive position in the media and entertainment industry. We think Disney's broad range of content and growing international presence (Shanghai Disney Park is opening in 2016) will allow the company to extend its global reach for many years to come.

Disney earned $4.95 per share in its fiscal year-end September 29, 2015 and should grow earnings at approximately 15% in the next fiscal year, to $5.68 per share. The company will generate close to $9 billion of owner earnings and is expected to return a large portion of this cash to stockholders through share repurchases of approximately $6 billion and dividends of $2.4 billion. We are enthusiastic owners of Disney, as the company exponentially increases value for shareholders through its global expansion.

COMMUNICATIONS GROUP

AT&T

Throughout 2014 and 2015, we built a rather large position in AT&T. Just about everyone is aware of AT&T, the communications juggernaut that has been in operation for more than 135 years.

Last year we reviewed the history of AT&T, and how over 70 years, the company became a so-called sanctioned monopoly that acted as a regulated utility, providing fair service at a fair price to its customers. In turn, investors in AT&T were offered a steady and reliable return. Of course, like other past infrastructure

monopolies that emerged in the U.S. over the past century, such as Standard Oil and United Aircraft and Transport (trivia point: United Technologies, Boeing, and United Airlines were once a single company), AT&T's stranglehold over the communications network eventually was challenged, leading to an antitrust lawsuit against AT&T by the U.S. government. The suit began in 1974 and was settled in January 1982, when AT&T agreed to divest itself of the wholly owned Bell operating companies that provided local exchange service. The government believed that separating the local exchanges would lead to competition that would lower prices to consumers as well as break up a monopoly that had existed for approximately 100 years.

With the breakup of the conglomerate into regional telephone companies, long-distance telephone service became a fiercely competitive business. Over a 12-year period beginning in 1984, AT&T's market share fell from more than 90% to around 50%. It turned out that the government was right—telecommunication prices plummeted, dropping by an average of 40% by the late 1980s. Of course, lower prices led to an explosion in volume. In 1984, AT&T had carried an average of 37.5 million calls per average business day; by 1989, the equivalent volume was 105.9 million, and 270 million in 1999—a new communications era had been born. With the advent of the Internet, an ever-increasing percentage of the traffic on AT&T's network was data and video rather than voice, and AT&T "2.0" evolved from a long-distance company to an integrated voice and data communications business.

A Renewed AT&T and Globalization

The renewed AT&T is a global Internet Protocol (IP) networking provider dedicated to delivering powerful networks, applications, and capabilities to business, government, and consumers. Today's AT&T provides sophisticated communication services, including wireless technology, broadband, and Voice over Internet Protocol (VoIP) for consumers and businesses.

In July 2015, AT&T further expanded its communication capabilities by completing the $48.5 billion acquisition of DirecTV. DirecTV is a leading satellite broadcast provider of digital television entertainment in the U.S. and Latin America. Satellite broadcasting is an alternative to cable service. With a subscriber base of more than 20 million in the U.S. and more than 18 million throughout Latin America, DirecTV is a global opportunity that generates more than $2.5 billion in annual profits. The combination of AT&T and DirecTV is enabling these companies to leverage their unique capabilities to exploit a global communications opportunity. AT&T's expertise and offerings in networking, wireless, broadband, and IP, coupled with DirecTV's satellite broadcasting network, creates a powerful platform for AT&T to develop globally—and that expansion is quickly taking place.

Prior to closing the DirectTV acquisition, AT&T acquired several wireless companies in Mexico. First, in January 2015, the company acquired the Mexican wireless company, Iusacell, for $2.5 billion. Iusacell, with six million subscribers, offers wireless service under both the Iusacell and Unefón brand names, with a network that currently covers about 70 percent of Mexico's approximately 120 million people. Following the luasacell acquisition, in early 2015, AT&T entered into an agreement with NII Holdings, Inc. to acquire its wireless business in Mexico for $1.88 billion. Nextel Mexico's network covers approximately 76 million people and has three million subscribers. The combination of Nextel Mexico with Iusacell allows AT&T to quickly improve and expand its mobile Internet service to the benefit of millions of customers in Mexico, serving many individuals who live outside of major metropolitan areas.

Today, AT&T represents a valuable company with growing global reach that offers customers a combination of data and video on all devices. We believe the company is a dynamic enterprise that is creating incremental intrinsic value for shareholders. In 2015, AT&T produced more than $14 billion of profits that was largely available for distribution to shareholders. AT&T's approximate 5.6% year-end dividend is among the highest of large companies and can be considered a fixed-income investment that has an opportunity to grow. We are excited owners of AT&T and believe that this "valuable" holding is providing us fair compensation today, with a global growth opportunity in the future.

COMMODITY-BASED HOLDINGS

Our commodity-based holdings include Chevron and ConocoPhillips, as well as smaller positions in several other oil companies. We have now held commodity-based positions for more than 10 years (since 2004),

primarily through an investment in integrated oil companies. At the time of our initial commodity-based purchases, we were concerned that higher oil prices may occur due to the possible deterioration of worldwide currencies, given governments' historical propensity to print money to stem the impact of any financial crisis in their countries. Of course, a financial crisis did occur in 2008/2009, and since then, we have been facing an ongoing financial predicament as governments work themselves out of the global financial quagmire—so far, the collective solution has been to print more money and debase currencies in the process. Even in 2015, there continued to be a vigorous debate (as well as emotion) surrounding volatile commodity-based investments and their reaction to either a deflationary or inflationary state that ultimately stems from excess government debt and currency debasement.

An Unexpected Surprise

In the last 24 months, the per-barrel price of oil has plummeted to the point that we can consider this commodity to have crashed. Since December 2013, the price of West Texas Intermediate crude oil has nose-dived from approximately $100 per barrel to $37 per barrel at year-end 2015. This 63% precipitous decline prompted us to reassess the long-term opportunities in our commodity investments.

We have concluded that our opinion has not changed since 2004: We remain concerned about the global financial system that seems to be encountering ongoing challenges with growing debts and imbalanced currencies—these two are tied.

Our first consideration involves the macro forecast of oil prices: In 2013, pundits had predicted that the per-barrel price of oil would be around $100 at year-end 2104—so much for that prediction. At that time, few predicted that oil would trade below $60 per barrel by the end of 2014. By December 2014, however, worldwide oil was trading at around $55 per barrel, with the U.S. Energy Information Administration (EIA) forecasting a $68 average worldwide price per barrel of oil in 2015. That was wrong—the per-barrel price of oil is now trading under $40. At the end of 2015, experts were forecasting that oil would be trading at between $27 and $37 per barrel throughout 2016, with several analysts predicting that the per-barrel price of oil would will ultimately settle below $20 (these predictions will likely be wrong, too). All this forecasting still seems silly to us, since many variables have impacted the short-term price of oil, including short-term imbalanced trends in supply and demand, a fluctuating dollar (as oil trades largely in U.S. dollars), shifts of distillate processing from one region to another, and so-called measures that are taking place in oil-producing countries—such as western countries imposing economic sanctions against Russia, or lifting them in Iran.

More important than focusing on the continuing oil price decline is the need to evaluate the domino impact that low oil prices can have on the global economy, which has not yet reverberated through the financial system:

- Reduced revenue is greatly impacting deficits and currencies for countries that are reliant on oil sales, such as Russia, Saudi Arabia, and Venezuela
- Reduced investment in oil drilling is having an impact on U.S. oil company earnings and employment
- Inexpensive gasoline is increasing fuel consumption, leading to purchases of larger automobiles and a delay in developing more energy-efficient transportation
- Banks and investors that have lent money to oil development businesses, as well as emerging market companies that borrow in U.S. dollars, are encountering loan stress
- As short-term global oil demand growth continues to slow while short-term supply remains plentiful, drilling and production is beginning to decline—oil companies are deciding to curtail capital expenditures for new drilling projects to preserve cash and wait for a future opportunity to produce oil at higher prices.

When rationally looking at the current global supply/demand equation, the EIA measurement of worldwide oil consumption is around 93.5 million barrels per day in 2015—representing an approximately 1% year-over-year increase—and forecasts a growth of another 1% in 2016, to 94.5 million barrels per day. Oil production, on the other hand, has increased to 95.5 million barrels per day by the end of 2015 to meet growing oil demand. All in all, the global oil supply remains ahead of demand, and we are continuing to experience an imbalance between oil supply and oil demand that will take some time to absorb. This absorption is beginning

to take place, and the EIA expects non-OPEC oil production to decline by .4 million barrels per day in 2016, which would be the first annual decline in non-OPEC production since 2008.

Where is Founders on all this? It is still our opinion that a long-term imbalance continues to grow between the current "easy" oil supply and global demand. The ongoing decline in the price of oil is also being impacted by extreme investor emotion and short-term trading. We keep in mind the 2013 World Energy Outlook report issued by the International Energy Agency that expects daily worldwide oil consumption to rise to approximately 101 million barrels per day by 2035. Considering the growing rise in demand, we are well on our way to this figure. Although supply vs. demand is slightly imbalanced today, it is our opinion that "safe" worldwide oil production capabilities are about equal to current demand. We believe that the future oil needed to meet rising demand is going to be "less easy" and more expensive to get out of the ground. The future oil supply to meet growing demand will come from further fracking in the U.S., tapping oil sands in Canada, and deep-water drilling in the Gulf of Mexico and Arctic Circle. With the ongoing oil price crash, many projects in these areas are now being mothballed. (In 2016, global exploration-and-production investments will fall by $170 billion, or 20%, according to Rystad Energy, an independent oil and gas consulting firm.) But the effects on oil prices from companies such as Chevron and ConocoPhillips reducing capital expenditures by 20%, and placing future production projects on hold, are yet to be determined—the length of time these complex projects take to reinstate is not widely appreciated. Since the total marginal cost for the largest oil and gas companies to produce the next barrel of oil to meet demand growth remains higher than $90 per barrel from the more difficult drilling sites, mothballing complex projects needed to produce future oil to meet energy demand could have a domino impact we may not expect—such as a long period of higher oil prices as rising demand eventually becomes more difficult to fill. In summary, we believe that the cost of producing a barrel of oil to meet long-term growing energy demand will be the ultimate determinant of the price of oil—we just don't know exactly when this will be realized.

Oil Company Investments

We made our initial oil investment in Chevron—a leading international integrated oil and gas company with operations worldwide—in early 2005. At that time, we felt rather confident that an imbalance in worldwide oil supply and demand would push long-term oil prices higher, increasing profits of integrated oil companies. Despite a crash in oil prices over the past two years, we remain committed to an investment in integrated oil companies. We believe that "valuable" enterprises such as ConocoPhillips and Chevron are now trading at a significant discount to their long-term intrinsic business value.

In the meantime, our combined oil holdings continue to produce cash for shareholders—the average dividend being paid by our oil company investments exceeds 5.5%. (Both Chevron and ConocoPhillips reiterated their commitment to maintaining the current dividend during the tough environment facing the oil industry.) Given the initial high rate of return received through shareholder dividends on our oil company investments, we can afford to be patient and wait for higher oil prices brought about by the mix of increasing global demand and oil production from costly-to-produce oil fields.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a .32% gain in 2015. This gain follows a 5.97% gain in 2014, along with an average annual bond index gain of approximately 3.26% over the past five years. We have emphasized in the past few years how investors have poured money into bond funds since the credit crisis of 2008. Since this extreme flight to safety has taken place, we have stated that most individuals have lost a business perspective by chasing returns in the credit market. We feel as strongly today—and perhaps even more so—about this viewpoint as we did when we first wrote about it—investor insanity has gone on for a longer period of time than we had anticipated (though this phenomenon is not unusual).

When evaluating the current fixed-income market, we believe individuals would still be *far* better off taking a business approach to their investing. We reiterate one more time: If individuals stepped back and looked at their fixed-income investments in a similar manner to an investment in a business, they would become skeptical about their future returns. Let's say that a business with zero debt is able to produce a steady 10%

return on equity. If management elects to retain the annual earnings of this business and plow the funds back into the company, investors can expect to see their so-called equity bond double in a little more than seven years.

Now let's look at a bond in a similar business light. If you purchase a bond that produces a 10% coupon and choose to retain the annual earnings from this bond and reinvest the money into the same bond at par, you will also double your money in a little more than seven years—producing a similar result to our business example.

Taking this example into consideration, it is our opinion that individuals purchasing bonds today are not taking a business perspective. For example, if we purchased a 30-year U.S. Treasury bond on December 31st at a 3% yield and chose to reinvest the coupon payments into these same bonds at par, it would take around 24 years to double our money. If we presented our clients with a similar arrangement to invest in a business that produces a 3% return on equity and retains all the proceeds to repeat this poor return, our judgment would be severely questioned, regardless of whether the business was assured survival. Unluckily, today's absolute abysmal return of 3% on a 30-year U.S. Treasury Bond is guaranteed to lose money against inflation that averages above 3% over the next 30 years (we will once again stay away from any forecasting). Unfortunately, many financial managers continue to place a greater-than-average portion of their clients' assets in *un*businesslike opportunities. (This does not mean that bond prices will not continue to rise—investor panic and/or deflationary pressures may attract additional money to fixed-income investments during 2016, even at low yields.)

We continue to emphasize several points that concern us about fixed-income instruments: Besides the ongoing poor returns being generated in this area, looming risks associated with this "secure investment vehicle" include future rising interest rates and even greater chances of default. We remain concerned about low long-term market interest rates, which are starting to move upward as the Federal Reserve begins to slowly change direction on maintaining a low interest rate environment. As the economy continued to modestly improve during 2015, the Federal Reserve instituted its first short-term interest rate hike in 10 years. The Fed's action will ultimately put pressure on the value of fixed-income instruments. Although many think that fast-rising interest rates are still a distance off, our experience with oil this past year should illustrate that the crowd is often wrong. Market interest rates could unexpectedly move upward in the near future, which would place tremendous pressure on low-yielding fixed-income investments.

In 2016, we have ongoing tranches of municipal and corporate bonds coming due. We will maintain a businesslike attitude toward our fixed-income investments, carefully allocating money to securities that offer a fair risk and return over the duration of the holding. Last year, we explained how we had placed fixed-income capital in "callable bonds" and "convertible securities" that we felt provided safety, with an adequate return. After opportunities dissipated in these areas, we have been placing funds in "reset" bonds that provide a margin of safety in a rising-interest-rate environment.

Reset (or, Fixed-to-Float) Bonds

A reset bond, or fixed-to-float bond, is a fixed-income instrument that increases its coupon rate on a designated date (called a reset or fixed-to-float date) to ensure that the market value of the bond does not severely deteriorate in price, especially as interest rates rise. For example, suppose a bond is issued with a price of $1,000 at a coupon rate of 5% between today and January 2020—at that time, the bond will "reset" to the short-term bank borrowing rate (let's say 2.25%), plus a premium of 3.25%. In this case, in January 2020, the bondholder would begin to receive a coupon equal to 5.5% on the $1,000 investment. In addition, this bond's coupon would reset each subsequent quarter at the then short-term bank borrowing rate, plus 3.25%. If interest rates continued to rise and the correlated short-term bank borrowing rate increased to, let's say, 3%, then the bondholder would receive a coupon equal to 6.25% for that quarter. Essentially, a reset (or, fixed-to-float) bond provides the bondholder protection of principal in a future rising-interest-rate environment while receiving a fixed interest rate of interest between now and the reset date.

In our case, as our bonds have matured or been called in by issuers during 2015, we have replaced a portion of the proceeds in reset bonds. During 2016, we will continue to look for alternatives as bonds mature and/or callable bonds are redeemed.

* * *

OUR FINAL THOUGHT

Since we emphasized the importance of intrinsic value throughout this letter, an expansion on this thought is probably a good way to finish. According to the Stanford Encyclopedia of Philosophy:

> *Intrinsic value has traditionally been thought to lie at the heart of ethics. Philosophers use a number of terms to refer to such value. The intrinsic value of something is said to be the value that that thing has "in itself," or "for its own sake," or "as such," or "in its own right." Extrinsic value is value that is not intrinsic.*
>
> *Many philosophers take intrinsic value to be crucial to a variety of moral judgments. For example, according to a fundamental form of consequentialism, whether an action is morally right or wrong has exclusively to do with whether its consequences are intrinsically better than those of any other action one can perform under the circumstances. Many other theories also hold that what is right or wrong to do has at least in part to do with the intrinsic value of the consequences of the actions one can perform. Moreover, if, as is commonly believed, what one is morally responsible for doing is some function of the rightness or wrongness of what one does, then intrinsic value would seem relevant to judgments about responsibility, too.*

At Founders Capital Management, we feel a great responsibility—both morally and ethically—to our clients. We understand that each of you has placed your money in our trust, and we want to ensure that you understand how much we value this faith. Our ethos is to value your money as if it is our own, and this is why we philosophically invest alongside our clients. This ensures that we are all in the same boat and that the intrinsic value of our businesses, our clients' well-being, and our own well-being are interdependent. In our opinion, this is not only morally right, but a moral obligation.

Each of us at Founders Capital Management is grateful for your business and, more important, your faith in us. Without your invaluable dedication and commitment to us, we would not be where we are today— this is certain. We thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2016.

The examples and descriptions of investments in this client letter do not represent all of the investments purchased, sold, or recommended by Founders and instead represent:

(1) the 10 largest equity positions held by Founders' clients;
(2) the two largest equity positions in each industry group to which Founders has allocated capital; and
(3) all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.

The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.

The views expressed in this report represent the opinion and analysis of Founders Capital Management based on data available from public sources at the time of writing. This report is not intended to provide any recommendations with respect to the purchase and/or sale of any specific security. It is recommended that individuals conduct their own research or consult with an investment advisor prior to making any investment decisions.

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