OPPORTUNITY FUND L.P.

INVESTMENT PHILOSPOHY

INTRODUCTION

This is a summary of our approach to investing in common stocks.

This summary is divided into three sections:

1. Great Businesses
2. Valuation
3. Investment Strategy

1. GREAT BUSINESSES

We only invest in what we believe are great businesses. What is a great business? Over the long term, the value of a company will follow the earnings of the company underlying it. Because the value of a business is determined by its' future profit generation, a "Great Business" should be defined as one that is great at generating profits now, and that will be able to continue to do so in the future. Businesses create a profit by selling a good or a service at a price above cost. Because profits determine value, it is imperative that we understand the business that produces the profits. We identify certain specific business and financial characteristics that are important in determining if a company is in fact a "Great Business". The absence of any one of these characteristics may indicate that a business is not great. The characteristics of a Great Business are:

1) Recurring revenue
2) A durable economic moat
3) High returns
4) Growth

1. Recurring Revenue – ***Product or service is always in regular and recurring demand.***
The first business characteristic that is of central importance to us is recurrence of revenue. Because the first thing a company must do to make a profit is sell it's product or service, it is a very good thing if the customers buy the product or service on a regular basis. Having a customer base that wants your product again is nice. Having customers that "need" your product again on a regular or recurring basis is ideal. People need haircuts every couple of months and shoes wear out regularly. For many people, a morning coffee is a must. We seek companies that have a recurring nature to their revenue.

2. A Durable Economic Moat – ***Product or service consistently sold at a high profit.***
Generating revenue does not guarantee a profit. When analyzing a company we consider not just net and operating income margins, but also gross margin. Gross margin is one of the most useful measures of business quality. Enduring high gross margins are earned, they are not naturally occurring. Generally, a company that has sustained high gross margins has invested heavily to differentiate its' product from its competitors products. Most businesses do not have the ability to raise prices without seeing a decline in unit demand because most businesses have competition willing to sell identical or similar products. It is for this reason that we seek businesses that have pricing power. These businesses should not experience gross margin pressure because they have a differentiated product. Differentiation comes in many forms but generally is a result of "brand equity" or technological superiority. High gross margin businesses typically have large relative expenditures on R&D and/or Marketing. Intelligent R&D and Marketing spending can build a most useful "moat". Such a moat provides not just higher margins and higher returns on capital but also a dependable margin of safety.

3. High Returns – ***Business does not require a lot of capital to produce and thus generates a lot of cash or "owner" earnings.***
We seek businesses that are able to make a high return on the amount of assets and equity employed on an absolute basis. In some businesses all or much of the profits from this year's efforts need to be reinvested to make next years' targets. Such "capital intensity" is frequently the sign of a poor business because it is indicative of lower owner earnings (see next section) and lower returns on assets and equity.

4. Growth – ***Demand for product or service will most likely see growth.***
The net present value of a security is the discounted value of all future cash flows. This equation is often referred to as "the Gordon Model." Valuing a bond is easy because future cash flows are predetermined. This is not the case with operating companies. We are concerned with growth of value and so we are concerned with how fast and long revenue can grow. Earnings growth is important, however, expanding net margins are finite. If sales grow forever, then theoretically, our profits and value can as well. It is for this reason that we look for businesses whose products will have the highest likelihood of increased demand not just in the next few years but over the long-term.

2. VALUATION

Identifying what we want to buy is half of the problem. We must also determine what price we should pay for Great Businesses. Now we will talk about how to find superior investment values by augmenting traditional valuation measures.

Owner Earnings

The E in P/E is earnings as reported on a company's income statement in compliance with GAAP (Generally Accepted Accounting Principles). GAAP are applied to a company's income statement in an effort to match revenues and expenses. Sometimes these adjustments are indicative of economic reality sometimes they are not. Real business owners know that acceptably accounted for earnings may not be legal tender. We consider not reported earnings per share, but realistic cash earnings that we would expect to take home if sole owner of a business – so-called "Owner Earnings" ("OE"). Without a clear understanding of the Owner Earnings of an enterprise, valuation is nothing more than guesswork. Rather than rely on GAAP earnings, one can get a better picture of a company's profitability by examining closely the income statement in conjunction with the cash flow statement and making all relative adjustments.

Owner Earnings Power

Owner Earnings Power ("OEP") is the amount of owner earnings that a company has demonstrated it can generate under normal business conditions. Occasionally even some of the greatest companies get into some short-term trouble. In many cases, this means that a company is not able to report GAAP earnings that meet the expectations of a generally myopic Wall Street. When a company "misses" the result is frequently a dramatic decline in a company's stock price - often to levels that an intelligent investor can take advantage of. At such times, a company may look expensive when compared to currently reported GAAP numbers. However, because we are concerned with the real Owners Earnings of a company, and not the amount of GAAP EPS it will report this quarter or even this year, we will find the greatest opportunity in these situations.

Once we have calculated Owner Earnings, we examine potential investments on two valuation measures:

1. Owner Earnings Yield (Owner Earnings/Price)
2. Owner Earnings Power Yield (Owner Earnings Power/Price)

Owner Earnings Yield & Owner Earnings Power Yield

It is Owner Earnings Yield and Owner Earnings Power Yield with which an equity investor should be primarily concerned. How that yield compares with the so-called "risk-free" rate and prevailing market multiples determines the attractiveness of a company at its current price. Furthermore, it is very important that we consider not just current earnings, but realistic expectations of the amount of Owner Earnings our companies can generate in the future.

Benchmarks
We use both the risk-free rate and the reciprocal of the prevailing market earnings multiple to determine if our investment choices offer sufficient risk-reward characteristics.

Benchmark One – Stocks vs. Stocks
The primary point of reference is the prevailing earnings yield or P/E of the stock market as a whole. Because we are playing a game of relative value, we must have a good sense of what other risk/reward opportunities are available within the equity markets. Contrasting the P/E of the overall market with the P/OE of a business, and the reciprocal of the risk-free rate will tell you almost everything you need to know about the "value" of an investment opportunity.

Benchmark Two - Stocks vs. Bonds
The "risk free rate of return" is the reference point from which all investments should be measured. Because it is this rate that we are foregoing in search of higher returns. Therefore, as our investment risks get greater, the return we expect needs to increase to justify the higher risk. For sake of simplicity, we will define the current risk free rate as 2.02%, which is where 10 year treasuries currently trade (10.18.15).

Valuing Growth
One trap that many investors fall into is avoiding businesses that have high valuations based on current reported earnings. I would rather pay 25x earnings for XYZ Corp. than 45x earnings. A 25x multiple implies a 4% yield and a 45x multiple implies a 2.2% yield. Versus 4%, 2.2% looks expensive. However, if the XYZ Corp. is growing EPS at 50%, the yield in five years will be 11% of cost. One must consider not just the current yield of earnings, but the <u>future</u> yields as well. For a Great Business, the steeper the slope of a company's revenue growth, the higher the multiple we should be willing to pay. Perhaps the most instructive work in this area comes from Peter Lynch who wrote extensively of the PEG ratio or Price/Earnings/Growth Rate. The PEG ratio is a method for comparing current price with estimated future yield. (We use POEG). Paying higher PEG multiples means accepting lower current earnings yield - which can be dangerous, especially if a company has not <u>proven</u> that it can generate higher earnings yields. When investing in growing enterprises it is imperative to understand the quality of earnings and the "moat" around the business.

The Balance Sheet
Many investors call themselves "value" investors and frequently reference Graham and Dodd as influences. Typically, these investors seek their "margin of safety" on the balance sheet. Theoretically, there is a very real margin of safety in low price to book stocks. A superior margin of safety is that which can be found on the income statement of a Great Business. Great Businesses should sell at considerable premiums to tangible book value because Great Businesses produce very high cash returns on their equity.

3. INVSTMENT STRATEGY

Patience & Selectivity
Great Businesses are rare. Great Businesses at cheap prices are very rare. If one is to insist on only buying Great Businesses and only paying reasonable prices that offer a margin of safety, one must be patient. Patience and selectivity are rare on Wall Street, but imperative for the successful investor. Importantly, investors should always stay within their "circle of competence" and invest only in businesses they understand.

Diversification
Most investors should diversify their portfolios broadly to include many asset classes. Low-cost index-based ETFs are almost always the best solution for such purposes. However, when seeking alpha, we believe strongly in portfolio concentration. Diversification is a means of lowering non-market risk. In our opinion, it is better to lower risk by making sure that our holdings have a margin of safety on their income statement.

Buy Strategy
The best time to buy Great Businesses is when they are cheap. With most Great Businesses, the price is rarely cheap. When you can buy a Great Business at an attractive price it will usually have faced a short-term problem. We will find the best prices when a business looks its worst to the stock market masses. We seek to buy Great Businesses when they are undervalued vs. their long term value.

Sell Strategy
We may sell our businesses for any one of three reasons: (1) if we believe that a better investment opportunity exists we may sell a stock; (2) if the market price of a stock is substantially above the company's value plus the tax burden realized from liquidation, or (3) should we realize that a business no longer is, or never was a Great Business, we will sell it. (This will indicate that we have made an investment mistake.)

If you are interested in our partnership that employs the aforementioned approach, please let us know.

Respectfully,

Kevin T. Carter