SILVER RING
VALUE PARTNERS

July 9th, 2020

Dear Partners:

I hope that you are well. I greatly appreciate the confidence that you have placed in me by entrusting me with your capital, and I appreciate your continued support. At the end of Q2 2020 the **portfolio was very attractively priced, with the Price to Base Case value ratio at 54%.** The portfolio had 14 investments, cash at 5% and option-adjusted net exposure at 78% at the end of the quarter. The ratio of Price to my estimate of Normalized EPS was 7x for a collection of businesses that I expect to grow profits at low-single digit rates on average over the long-term. I have selectively added to a number of put-option hedges and believe that the portfolio strikes a good balance between seeking a good long-term rate of return and minimizing the risk of permanent capital loss.

Partnership Performance			
	Last 12 Months	Since Inception (9/1/2016, Cumulative)	Since Inception (9/1/2016, Annualized)
Silver Ring Value Partners (Net)*	**5.7%**	**28.8%**	**6.8%**
Average Cash Levels	5%	24%	24%
Average Option-Adjusted Net Exposure	67%	63%	63%
Russell 3000 Index	**6.5%**	**51.4%**	**11.4%**
MSCI World Index	**3.4%**	**40.4%**	**9.3%**

*Results are net of all fees and expenses and use the 20% performance fee level above a 6% hurdle that represents the substantial majority of partnership assets over these periods
Partnership Results are audited through 12/31/2019 and unaudited afterwards

I was able to deploy the additional capital provided by existing partners in March and April at extremely attractive prices. The quality of our partners and the nimbleness afforded to us by the small size of the partnership allowed me to buy bargains at discounts to intrinsic value that I have not seen in quite some time. The market began recognizing these values much faster than I had expected, with Q2 seeing a number of price/value gaps fully or partially close. While the partnership has begun to benefit from these investments, I believe there is still a lot of potential left in our current holdings.

The environment is now far more dangerous than it was when I last wrote to you a quarter ago. The market, in part due to government intervention and in part due to retail speculation has bid up stock prices disproportionately to what is warranted by many companies' fundamentals. Deprived of their ability to visit casinos by COVID, some investors decided that they can save on the gas money and gamble from the comfort of their home via a convenient retail brokerage account. The speculative excesses have exacerbated the "tiering" of the market between exciting glamour stocks and small-cap and bargain-priced stocks. Since the beginning of the year, the Nasdaq 100 index is *up* over 20% whereas the Russell 2000 Value index is *down* over 25% - a spread of over 45%. I am not currently finding new attractive opportunities and am maintaining my usual high bar for margin of safety for any new investments. I am perfectly fine "missing out" on over-valued stocks getting bid up even higher. I am not fine losing our capital.

Silver Ring Value Partners Limited Partnership • One Boston Place, Suite 2600, Boston, MA 02108 • www.silverringvaluepartners.com

Executive Summary

At the end of Q2 2020 the portfolio was very attractively priced, with the Price to Base Case value ratio at 54%. The portfolio had 14 investments, cash at 5% and option-adjusted net exposure at 78% at the end of the quarter. My investment decisions are driven by bottom-up considerations, and cash is a residual of that bottom-up investment process. I do not seek to time the market, and I continue to rigorously stick to my criteria for quality and discount to intrinsic value.

	Portfolio Holdings		6/30/2020	6/30/2020
	Security		**% Portfolio**	**% Delta-Adjusted**
1	**COVETRUS INC**	**CVET US**	**22.4%**	**22.4%**
2	**Owens-Illinois Position**		**10.2%**	**21.1%**
	OWENS-ILLINOIS INC	OI US	6.5%	6.5%
	Owens-Illinois October 2020 Call Option, Strike = $12		0.6%	3.1%
	Owens-Illinois December 2020 Call Option, Strike = $10		1.2%	4.2%
	Owens-Illinois December 2020 Call Option, Strike = $12		1.8%	7.2%
3	**Undisclosed Position 4**		**13.5%**	**13.5%**
4	**Discovery Communications Position**		**11.6%**	**12.0%**
	DISCOVERY COMMUNICATIONS-C	DISCK US	11.56%	11.6%
	Discovery Communications September 2020 Call Options, Strike = $25		0.04%	0.4%
5	**Hopes and Dreams Puts (TSLA, ROKU, SNAP, WORK, BYND Put Options, Jan 2021)**		**3.5%**	**-11.6%**
6	**CHARLES & COLVARD LTD (previously Undisclosed Postion #2)**	**CTHR US**	**10.9%**	**10.9%**
7	**Carnival Position**		**4.0%**	**9.3%**
	Carnival October 2020 Bond		1.6%	1.6%
	Carnival September 20202 Call Option, Strike = $22.50		2.4%	7.7%
8	**Cintas (CTAS) August 2020 Put Option, Strike = $200**		**1.0%**	**-8.6%**
9	**Tail Risk Hedge (MAT, TEVA, HTZ, NFLX and THC Put Options, Jan 2021)**		**3.8%**	**-6.6%**
10	**ARCADIS NV**	**ARCAD NA**	**5.4%**	**5.4%**
11	**FOX CORP - CLASS B**	**FOX US**	**5.4%**	**5.4%**
12	**EBay Poisition**		**1.5%**	**3.2%**
	EBay (EBAY) Jan 2022 Call Option, Strike = $33		1.5%	3.2%
13	**BRISTOL-MYERS SQUIBB-CVR**	**BMY-R**	**0.8%**	**0.8%**
14	**BERKSHIRE HATHAWAY INC-CL B**	**BRK/B US**	**0.8%**	**0.8%**
	All Investments		**94.6%**	**77.9%**
	Cash & Equivalents		**5.4%**	

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Investment Activity

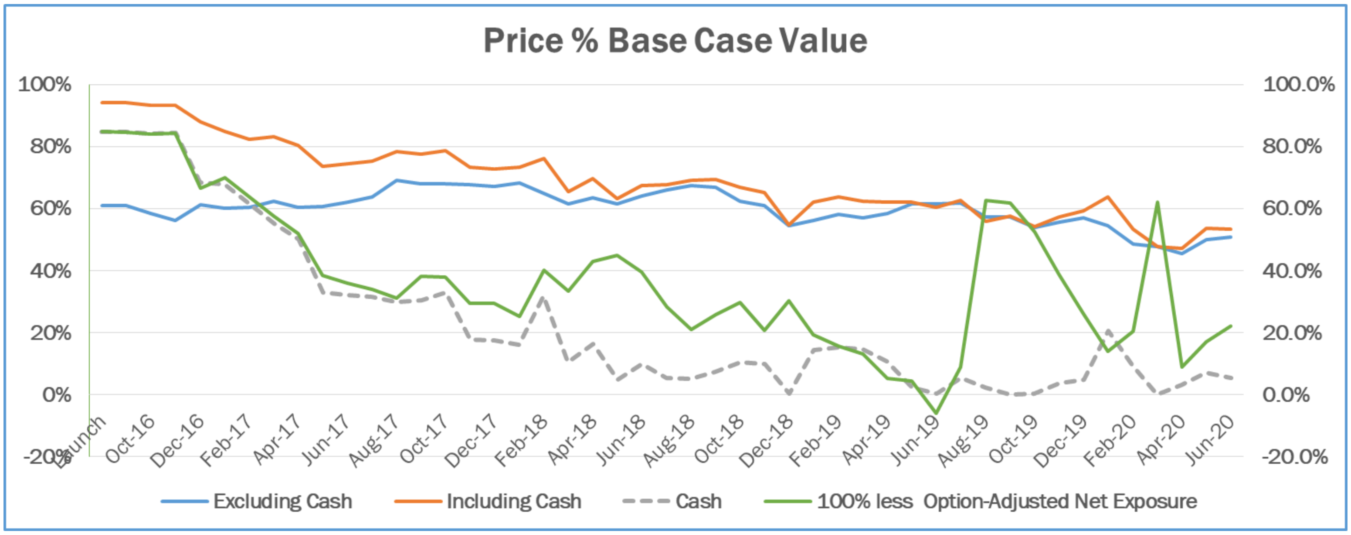
I made the following changes to the portfolio during Q2 2020:

- Made a 1% investment in the **Bristol Myers Squibb Contingent Value Rights (CVR)**
- Sold the Caesar's **(CZR)** merger arbitrage as the spread to the take-out price fully closed
- Bought Carnival (**CCL**) October 2021 **debt** (2%) and September 2021 **call options** (1%)
- Bought additional Cintas (**CTAS**) put options
- Added to the Charles & Colvard (**CTHR**) position
- Reduced the Covetrus (**CVET**) position by a fifth due to risk management parameters
- Sold ~ 40% of the eBay (**EBAY**) call option position as the price/value gap narrowed
- Slightly added to the Fox (**FOX**) position
- Substantially added to **Undisclosed Position #4** with the stock trading around net cash
- Exited our Gilead (**GILD**) position as the price/value gap narrowed substantially
- Made the following changes to the **put option** baskets: reduced **HTZ** and **THC**, added to **NFLX, TSLA, ROKU, MAT, SNAP, WORK** and **TEVA**
- Replaced a portion of our **OI** equity position with call options, freeing up some cash
- Exited our Medifast (**MED**) position as the stock reached 100% of my Base Case value
- Sold a put (which has since expired out of the money) and bought a September call on **DISCK**

Investment Thesis Tracker

Ticker	Company Name	3Q 2017	4Q 2017	1Q 2018	2Q 2018	3Q 2018	4Q 2018	1Q 2019	2Q 2019	3Q 2019	4Q 2019	1Q 2020	2Q 2020	3Q 2020
DISCK US	DISCOVERY INC-C													
AMT US	AMERICAN TOWER CORP													
INVA US	INNOVIVA INC													
CTHR US	CHARLES & COLVARD LTD													
GILD US	GILEAD SCIENCES INC													
CMPR US	CIMPRESS PLC													
ARCAD NA	ARCADIS NV													
GOG LN	GO-AHEAD GROUP PLC													
HIL US	HILL INTERNATIONAL INC													
CHUBA US	COMMERCEHUB INC-SERIES A													
RCL US	ROYAL CARIBBEAN CRUISES LTD													
AGN US	ALLERGAN PLC	Start->												
	Undisclosed 4				Start->									
OI US	OWENS-ILLINOIS INC					Start->								
EBAY US	EBAY INC					Start->								
FOX US	FOX CORP - CLASS B								Start->					
CRCM US	CARE.COM INC									Start->				
CTAS US	CINTAS CORP									Start->				
CVET US	COVETRUS INC										Start->			
BRK/B US	BERKSHIRE HATHAWAY INC											Start->		
BMY-R	BRISTOL-MYERS SQUIBB-CVR											Start->		
MED US	MEDIFAST INC											Start->		
CCL US	CARNIVAL CORP											Start->		

- White: thesis is tracking roughly in-line with my base case
- Orange: thesis is tracking somewhat below my base case
- Red: thesis is tracking significantly below my base case
- Dull Green: thesis is tracking somewhat better than my base case
- Bright Green: thesis is tracking significantly better than my base case
- Black: Investment exited



- The portfolio is attractively priced at 54% of Base Case value
- Option adjusted net exposure is at 78%, reflecting option-based hedges

Operational Update

- I switched legal firms to Wilmer Hale from Morgan Lewis for the partnership because the partner at the law firm that we were with switched firms. He has done an excellent and timely job for us, and I chose to follow him to his new firm and do not expect a difference in cost.
- I presented my in-depth thesis on Covetrus (CVET) at the MoI Global Wide Moat 2020 conference. You can watch the presentation here, and I am including the slides with the letter.
- I continued posting educational **investing videos** on my YouTube channel
- I wrote several articles on general investing-related topics at the ***Behavioral Value Investor***, a publication of Silver Ring Value Partners**, including**
  1. The Problem With The 60/40 Portfolio
  2. 3 Insights From Warren Buffett at Berkshire Hathaway's 2020 Annual Meeting

Portfolio Update

Investing Environment

The last three months have made many market participants forget about the first quarter. The Federal Reserve is buying almost anything in almost any amount that will lead to the asset prices that it desires. The U.S. Government dispensed a massive amount of fiscal stimulus to attempt to offset the impact from the crisis on the real economy. Economic indicators are rapidly improving, although largely by virtue of how sharply they previously fell. The weather is warmer, and crowds, tired of being cooped up inside, are increasingly venturing out and attempting a return to their prior life. The stock market has almost returned back to where it was pre-crisis.

The Wise Men and Women guiding our economy have saved the day. The worst is over, and it won't be long until everything – life, economic activity, and corporate profits –returns back to prior norms. Or will it?

My family went on a nature walk a few weeks ago. My oldest son, Ben, wanted to be the leader this time as he was a few days from turning 7. I was happy to oblige and let him lead. Ben took his job seriously, marching in front of us, looking alertly for which way to go next. We got to an intersection and he paused. I caught up to him and asked: "Ben, which way now?" He looked at me, now less certain, leaned in before the others caught up and said: "Well Papa, I don't actually know which way I am going. So I don't know where to go next."

Ben had the honesty that we are unlikely to get from the well-dressed experts at the Federal Reserve or other U.S. or global leaders. Part of their game is inspiring confidence that they are fully in control, know what will happen and how to handle it, and that therefore there is nothing for anyone to worry about. Keep asset prices high, and move along, nothing to see here.

Perhaps they are right. Everything can certainly turn out to be fine. However, I would guess that they are far less confident underneath their polished veneer than they would like us to believe. They don't know much more than we do, and their ammunition to impact the markets, while large, is not without limits. Ultimately their biggest weapon is getting markets to believe that they got this covered and that there isn't much to worry about regardless of what they really believe themselves. In a word, a bluff.

The market is a beast that cannot be tamed permanently. *Nobody* knows what will happen next or when the prevailing optimistic mood will change. It might or it might not. In the meantime, the opportunity set for bargains is once again not very attractive, and caution is the right posture in light of the carefree optimism of the markets. **When there is nothing intelligent to do, the only rational course of action is to do nothing and do your homework to be prepared for when good bargains reappear.** Given the discrepancy between the uncertainty that we face in the real economy and the complacency of the stock market that might be sooner than many think.

Extreme Options

Far out of the money options should be a very infrequent tool in the hands of a value investor. In most circumstances, buying such options is no better than buying an expensive lottery ticket. However, there are times when such options make sense from a value perspective, and currently we are in one such time period.

First, let's review how the market prices options. The standard model is the Black-Scholes model. I will spare you the math and instead go for a simplified analogy which hopefully captures the important elements from our perspective. The underlying assumption of the model is that stock prices move around randomly, centered on whatever the current market price is. There is also a "drift term" which the model uses to account for the increase in value with the passage of time, which is set at the risk free rate. Since the latter is currently zero, we can ignore it for the purposes of the current discussion.

So imagine a stock with a price of $100. Picture a vertical line on a chart at the $100 mark on the x-axis. Now imagine that someone draws a normal probability distribution (aka a "bell curve") around that vertical line. How wide or narrow this bell curve ends up being is determined by how volatile the market perceives the stock to be, which is usually based on how volatile it *has been* in the past. The wider the curve, the more expensive it is to buy an option at a given strike price. This makes intuitive sense – the more volatile we perceive the stock to be, the more likely it is to reach any price that is not $100.

When markets get nervous, they assume greater future uncertainty. This leads option market participants to embed a higher degree of volatility in future stock prices. The bell curve around our $100 vertical line becomes fatter. Conversely, when everything is calm and boring, option markets participants tend to expect lower future volatility in the stock price and the bell curve around $100 becomes skinnier.

What happens if the $100 stock price changes drastically? Let's say that for some reason the stock price goes from $100 to $20. The option model adjusts by drawing a new bell curve, this time around $20. It could care less that the stock was just at $100. The model assumes random movement around *the current price*, so if that is now $20, then that's where the model's bell curve will be. In most circumstances, the curve will also widen, since option market participants will expect higher future volatility than before the drop from $100 to $20. However, there is a limit to how much the curves widen in practice.

Now imagine you found a stock that just went from $100 to $20, but for which you think the *intrinsic value* only changed from $100 to $80. The option market's model will consider the probability of the stock reaching $80 an incredibly tiny probability, because that would mean a 300% increase in the price, which would put it far in the right tail of the bell curve that the option market has redrawn around $20. However, if we are right on our intrinsic value estimate, the likelihood of the stock price reaching $80 is much higher than the probability implied in the option price. So the price of a call option with a strike of $60 can be incredibly cheap – perhaps 50c or $1 given that the model implies that it's extremely unlikely to reach it. Buying such an option can produce 20x-40x return if the price to value gap closes before the option expires. **In other words, our fundamental value for such an option based on our intrinsic value estimate for the company is much higher than the market price for that option.**

Before everyone reading this runs out and puts all their savings in all kinds of speculative options, let's pause and be realistic. There are many ways in which we can still lose money in this situation. We can be correct in our value estimate but the option may expire worthless before the stock market corrects the price. We may be wrong on our value estimate. New events can occur which can lower the value of the business much lower, making our option worthless. So this is by no means something that can be a large part of a portfolio if we care a lot about capital preservation as I do. However, given the very high risk/reward in such unusual circumstances, a very small commitment of capital, say 1% or less, can result in a very meaningful gain if we are right on business value.

While the above example used call options, the same holds true for put options. If a stock that was worth $100 goes to $400 but our value remains at $100, then a put option with a strike of $200 may become meaningfully undervalued for similar reasons. This is in some cases currently applicable to some of the bubble names being bid up with little economic justification by speculators in the market. Again, there are no guarantees and this is something that should be used infrequently and in small quantities, but opportunities do occasionally present themselves to take advantage of the market's pricing mechanism for options.

Portfolio Activity

Hopes and Dreams Put Options Basket

I used the strong market price appreciation in speculative companies to add to the Hopes and Dreams put options basket during the quarter. These companies fit the "extreme options" mental model that I described in the earlier section of the letter as their prices appear to have completely disconnected from what is supported by evidence and economics of their businesses. I added to TSLA, SNAP, ROKU and WORK. On a mark-to-market basis the basket was ~ 3.5% of the portfolio at the end of the quarter. Most options in it have a ~ 10:1 potential payoff in case the current bubble in speculative names pops between now and January 2021. I plan to re-assess the basket in November if nothing meaningful happens until then, and decide whether/how much to roll-over the options vs. extract capital from the basket.

Carnival Corp

In early April, the stock price of Carnival dropped from a January level of $50 to $8. Given the COVID crises and a ban on cruising, the company quickly went from meaningful profitability to burning cash. Furthermore, management found it necessary to raise capital on distressed terms via secured senior debt and a small secondary equity offering. This capital provided the company with enough liquidity to survive for over a year even if cruising does not resume.

My analysis suggests that under most scenarios this business will return to normal at a future point. I have followed the industry for 15 years, and every time some health crisis scared off passengers, a year or two later business was back to normal. We can of course argue that this time is different, but the evidence is that it is not. The company is already seeing bookings for the 2021 season in the normal range (albeit with very favorable cancellation provisions).

We certainly don't know how long it will be before cruising will return to normal or how much cash the company will burn in the meantime. There are some scenarios where the company will return to normal demand and profits, but that in the meantime the equity is wiped out or greatly diluted. All kinds of permutations of events (e.g. big second wave, the virus mutating into a new dangerous strain, etc) could wipe out the equity if the company, which has high fixed costs, is forced to not sail its ships for a long time.

We do know that this is an industry leader with ~ 50% market share which has earned slightly more than its cost of capital over the full economic cycle. Structurally the business has not changed, and once demand is restored the industry economics are likely to be similar to the past. If we look at the company's balance sheet, the replacement cost of its fleet is over $40 per share after taking into account the debt. So as long as this business is a going concern and demand is restored to prior levels, a base case value of around $40 is reasonable. Without any cash burn the business would be worth north of $50, and we can treat the cash burn and the time value of money as getting us to around $40 of equity value.

I did not think that the equity at $8 was the best investment. The downside was $0 and I didn't know the probability of that downside occurring. However, there were two securities that I did think were very attractive, especially in combination:

- *After* the capital raise occurred, the October 2020 senior unsecured bond was yielding over 12% to maturity. Importantly, the company already had the cash on hand, set aside to payoff this bond from its recent capital raise, so the risk of default is very low. If a default does occur we would get our share of their ships at a fraction of their replacement cost, or more precisely our debt would likely become equity in a new company with a cleaned-up balance sheet. I made this a 2% position in April.
- The September 2020 call option with a strike of $22.50 was trading at 50c. That meant that if I was right and by September the price to value gap closed to $40, we would receive a 35x payoff. Clearly there are many scenarios where this option expires worthless, but for reasons that I explained in the "Extreme Options" section earlier in the letter I analyzed the option to be much undervalued and an attractive risk/reward. I made it a 1% position in April. Since then, as the stock spiked I took out a small portion of the profits from the option to manage risk and recovered more than our original cost basis while maintaining our upside if the price/value gap continues to close.

Covetrus (CVET)

In the depths of the March/April sell-off I was able to add a large number of shares to our CVET position in the $5-$6 price range. This was less than either of the two businesses within the company are worth and a small fraction of my $28 base case value estimate. When the stock tripled quickly and became a very large part of the portfolio I began gradually reducing the position in order to comply with my risk management parameters on position sizing. I did so reluctantly since I think the business is still substantially undervalued and the company remains our largest position.

I have recently presented CVET at the MOI Global Wide Moat 2020 conference, and you can view the presentation here. I am also enclosing the slide deck covering my thesis on the company in-depth and detailing the time of all portfolio activity through the end of Q2 pertaining to CVET so that you can see exactly how and why I made the decisions that I did.

Undisclosed Position #4

This has clearly been an unsuccessful investment thus far. What's more, the company's business positions it squarely in the path of the economic fallout from the COVID crisis, delaying any progress we might otherwise have seen. Offsetting these facts are the following:

- The stock is currently trading at/below cash per share with no debt
- We have a founder-CEO most of whose net worth is in the company's stock who is working incredibly hard to create value for all of us

- The company recently disclosed that it has not burned any cash through the third week of June. I do expect the company to burn a small amount of cash in 2021/early 2022 in some scenarios, but the asset-light nature of the business should preserve most of the cash
- The chaos in the company's industry presents both challenges and opportunities. The opportunities stem from the fact that competitors are also now in disarray and it is easier to try new things and perhaps build a competitive advantage than it would be if the competitors were fully focused on execution. This is by no means easy or even the base case, but the possibility to create value is there and management is motivated.

Given the events, I re-underwrote the business value from scratch. I believe this presents a very unusual asymmetric value opportunity where the probability of meaningful capital loss from here is small, and it is very easy to see returns in the 100%-300% range from these price levels. I have been gradually moving the position size from medium to large to reflect the opportunity.

Owens-Illinois (OI)

With the stock around $7 I replaced a portion of the equity position with a combination of cash and far out of the money call options. The latter were very undervalued for reasons described in the Extreme Options section of the letter. The former gave us opportunity to add capital to other very attractive investments. I intend to manage the position between equity and options based on a number of considerations, including where the biggest mis-pricing is at a given point in time and also the opportunity cost of capital based on where else I can deploy the cash.

The company's business is still impacted by the economic fallout from the crisis, but is starting to improve. The current demand run-rate has been very low double-digits decline, a rate of decline that I expect to improve throughout 2020 as up until recently the company has been shut down by governments in parts of the world where it was considered non-essential.

This is still one of the more undervalued companies in the portfolio with very strong upside once the business stabilizes. I know that cheap small-cap companies with leverage are currently extremely out of favor, but as long as I am approximately right on the cash flow stream we should benefit from the company's substantial free cash stream over time.

Gilead (GILD)

This has not been a successful investment for the partnership. My value estimate has come down moderately over time. While the core HIV business performed slightly better than I expected, the HCV business did worse, and the pipeline has not thus far produced the expected contribution to the revenue stream.

The new CEO seems focused on early stage M&A to fill the pipeline rather than buying back undervalued stock, which was disappointing. I get that doing exciting M&A is more fun than boring share buybacks, but it's not clear to me that it creates more value for the shareholders. Certainly the company has the cash flow and balance sheet for both, and the fact that management chose to not buy back a meaningful amount of shares is a negative.

The stock rallied to ~ 90% of my Base Case due to optimism for the prospects of revdesimir, the only approved drug for COVID. On a call the CEO was asked multiple times about the economics for the drug and dodged all questions with platitudes. Finally, an analyst asked him point blank if he expects to make a profit for the company on this drug. He dodged that question as well. The combination of these circumstances and the price/value ratio led me to conclude that it is time to move on, and I exited our position during the quarter.

One silver lining here is this unsuccessful investment illustrates the importance of the margin of safety that I seek when deploying our capital. A number of things went wrong, and we still were able to realize a small profit for the partnership on this investment. Not all my mistakes will result in such a benign outcome, but the fact that we were able to do so serves as partial validation of my disciplined value investing approach that seeks to protect our capital from permanent loss.

Bristol Myers Squibb Contingent Value Rights (CVR)

I made a small 1% investment in the CVR. The CVR will pay of $9 in 2021 if 3 drugs are approved by the FDA within the allotted timeline. The drugs are very late stage with plentiful evidence that approval is very likely. Even if we were to use average Phase 3 probability of approval the joint probability is well over 50%. The proxy statement reveals that management has specific financial incentives that will pay off only if the CVR gets paid.

I bought the CVR around $3.50, because it was trading meaningfully below my expected value. A nice bonus is that this is an investment that is uncorrelated with other things in the portfolio, and it has a hard catalyst of the deadline for the drugs to be approved. It certainly is possible that something goes wrong and one of the drugs either fails to get approval or misses a deadline, but our odds are good to make a small, uncorrelated profit.

Performance Discussion and Analysis

I encourage you to consider the results summarized below in conjunction with both the investment thesis tracker as well as the discussion of the individual companies in this letter. Price volatility usually far exceeds the changes in underlying business values, especially during a crisis.

Any investment process that is judged over less than a full economic and market cycle is liable to appear better than and worse than it really deserves at different points. When markets are going straight up, risk management and careful attention to valuation might look like an unnecessary drag on returns. On the other hand, when security prices are collapsing across the board, it might temporarily seem like we are permanently losing capital while in reality we are not. The benefit of measuring results over a full cycle is that it allows us to better separate the skill with which an investment process is applied from the violent fluctuations of prices caused by a manic market.

Performance Analysis (6/30/2020)		
	Last 12 Months	Inception - 6/30/2020 (cumulative)
Net Return (after all fees)*	**5.7%**	**28.8%**
Hurdle Rate of 6% per year	6.0%	25.0%
Russell 3000 (total return)	6.5%	51.4%
MSCI World Index (total return)	3.4%	40.4%
Average Cash & Equivalents % Portfolio	**5%**	**24%**
Average Option-Adjusted Net Exposure**	**67%**	**63%**
Contribution to Gross Return (before all fees)		
Positions (including equities and options that were part of each position)		
Covetrus Inc	16.4%	18.7%
Allergan Plc	3.4%	8.1%
Carnival Corp Position	3.2%	3.7%
Gilead Sciences Position	2.6%	1.0%
Tail Risk Hedge	2.4%	2.5%
Care.com (previously Undisclosed Position 5)	2.1%	2.4%
Caesars Entertainment	1.3%	1.5%
Medifast	1.3%	1.5%
eBay Inc	1.0%	3.6%
Cintas Put Position	0.7%	0.8%
American Tower Position	0.3%	5.0%
Berkshire Hathaway	0.0%	0.0%
Bristol-Myers Squibb CVR	-0.1%	-0.1%
Arcadis NV	-0.2%	4.4%
Fox Corp	-0.8%	-0.8%
Owens-Illinois Inc	-0.8%	-1.4%
Royal Caribbean Position	-1.0%	-2.6%
Hopes and Dreams Put Options	-1.1%	-1.3%
Undisclosed Position 4	-6.6%	-11.8%
Charles & Colvard (previously Undisclosed Position 2)	-7.6%	-2.0%
Discovery Communications Position	-8.0%	-3.9%
Cimpress NV		3.0%
Hill International (previously Undisclosed Position 3)		1.5%
Go-Ahead Group		0.5%
CommerceHub Inc		1.8%
Innoviva (previously Undisclosed Position 1)		2.6%

* Performance fee is presented based on the Founder's Class, which reflected the majority of the assets during these time periods

** Option-Adjusted Net Exposure adjusts for the use of options by replacing their

Disclaimers: Please see the "Disclaimers" section at the end of this letter

Your Questions

As I have committed to do in the Owner's Manual, I will use these letters to provide answers to questions that I receive when I believe the answers to be of interest to all of the partners. This quarter I received one question that I thought it would be helpful to address in this letter. (Please keep the questions coming; I will do my best to address them fully.)

How can we be sure that value investing will continue to work in the future?

We cannot be sure. What has worked in the past is not predictive of what will work in the future. However, if we dig deeper into *why* value investing has worked for a long time, we are likely to get insights into what may or may not continue to work in the future.

First, what do we mean when we say "value investing?" Historically, most people using this term have referred to the practice of purchasing stocks at a price that is low relative to some fundamental measure such as earnings or book value. The term was used in contrast to "growth investing" which typically involved purchasing stocks at relatively high ratios of earnings or book value based on the expectation that the company's future growth potential would compensate for that starting disadvantage.

There are a few reasons why over long periods of time such "statistical cheapness" approach to value investing has worked in the past:

- **Behavioral Biases** – investors tended to over-extrapolate recent problem of companies into the future far disproportionately to what was rational based on thorough analysis
- **Institutional Constraints** – professional investors had or felt that they had asymmetric career/business risk from holding the "ugly ducklings" of the investing universe. On the other hand, mediocre outcomes achieved by following other investors into well-known popular companies was rewarded with disproportionate personal financial gains for professional investors
- **Informational Inefficiency** – Up until the last two decades uncovering statistically cheap stocks took significant manual effort
- **Short-term Time Horizon** – most investors want or need validation of their approach sooner rather than later, and few are willing to wait for a number of years before seeing their investments work out. The focus of such short-term investors naturally shifts to companies where the current fundamental trends are positive. Value investing on the other hands had many multi-year periods where it performed poorly relative to other approaches, thus pushing away all but a few investors with a long time horizon

The result has been that cheap stocks tended to outperform over long periods of time *on average* as their very low starting valuation more than offset their unexciting fundamental prospects. Conversely, highly priced “growth stocks” tended to underperform over long periods of time on average *despite* the fact that the underlying companies’ fundamental performance has been far superior to that of “value stocks.”

Of the four reasons that I previously listed for why value investing has worked in the past, Informational Inefficiency clearly no longer applies with the prevalence of sophisticated computers and financial databases.

The next most vulnerable reason for past outperformance is the behavioral bias against companies with poor recent performance. This is only a potential source of future stock outperformance if the problems are on average temporary and the companies tend to recover at least some of their past earnings power to a degree greater than the implied expectations in their low security prices. That does not have to be the case. If low statistical valuation is on average associated with companies that are about to have their profits reduced even further than their stock prices are discounting, or worse yet if it’s the final stopping point on the way to bankruptcy, then what used to be a bias that pointed investors in the wrong direction could become a useful heuristic that can help them avoid disaster. This is not to say that this has happened and will remain so, but rather that cheapness in stocks, even as a group, need not be *unwarranted*.

The remaining two reasons for the historical success of value investing are structural and will not change. My 15 years at several large mutual fund firms prior to starting Silver Ring Value Partners attest to the fact that Institutional Constraints are just as pervasive as they have ever been. The old adage that it is better to fail conventionally than to succeed unconventionally certainly holds true among professional money managers who are strongly discouraged from straying too far from the herd. On the other hand, the industry’s marketing prowess has translated into large and frequently undeserved excess profits that have allowed for outsized compensations for those money managers who don’t rock the boat and play the game the way their firms want it to be played, even if their clients end up worse off for it. I see no change to this dynamic on the horizon.

Investors’ time horizon has not, and is very unlikely to get any longer. The desire for quick gratification is ingrained in both human nature and the business incentives of most professional money managers. It is a rare professional investor who can have horrible 3-year results and survive for long in the business without losing clients or their job.

This analysis leads me to believe that value investing defined as buying groups of statistically cheap stocks should do worse than it has done in the past. How much worse is hard to know. However, there is an argument to be made that the two unchanged factors that led to the strategy’s past success, Institutional Constraints and Short-term Time Horizon, are enough to produce a moderate excess return over time under most conditions.

Statistical cheapness, however, is not the only definition of value investing. An alternative definition is *intrinsic value investing*. This approach does not rely on below-average multiples of earnings or other fundamental metrics per se. Instead, it aims to value the underlying company based on excess assets and the net present value of future cash flows and then buy the stock at a large margin of safety to that estimate of value. The result can be that a statistically cheap stock may be over-valued and a high multiple stock may be undervalued.

If the valuation analysis performed by an investor who is following an intrinsic value approach is exactly correct, this approach *has to* work. If. In practice, nobody is ever going to predict the future precisely for any business. Getting the future cash flow stream even approximately right is quite challenging for many companies. So what is at a philosophical level a very sound approach that should work, at a practical level is a difficult discipline to master.

In the hands of the wrong practitioner, the idea of intrinsic value becomes merely a fig leaf to justify paying whatever price they want for a company. Want to buy some glamour company without any profits? Not a problem. Just create a spreadsheet with future forecasts that justify a value today higher than the price, and you can claim to be practicing an intrinsic value approach. By switching from a statistical cheapness to an intrinsic value interpretation of value investing we are trading a less effective but objective approach to a potentially more effective but much more subjective investing system.

A skilled practitioner practicing an intrinsic value approach with a long-term time horizon and in the absence of institutional constraints is very likely to do better than market over time. However, such a skillset is much more difficult to develop, and few possess it in combination with the *temperament* required to stay rational during turbulent periods in the market.

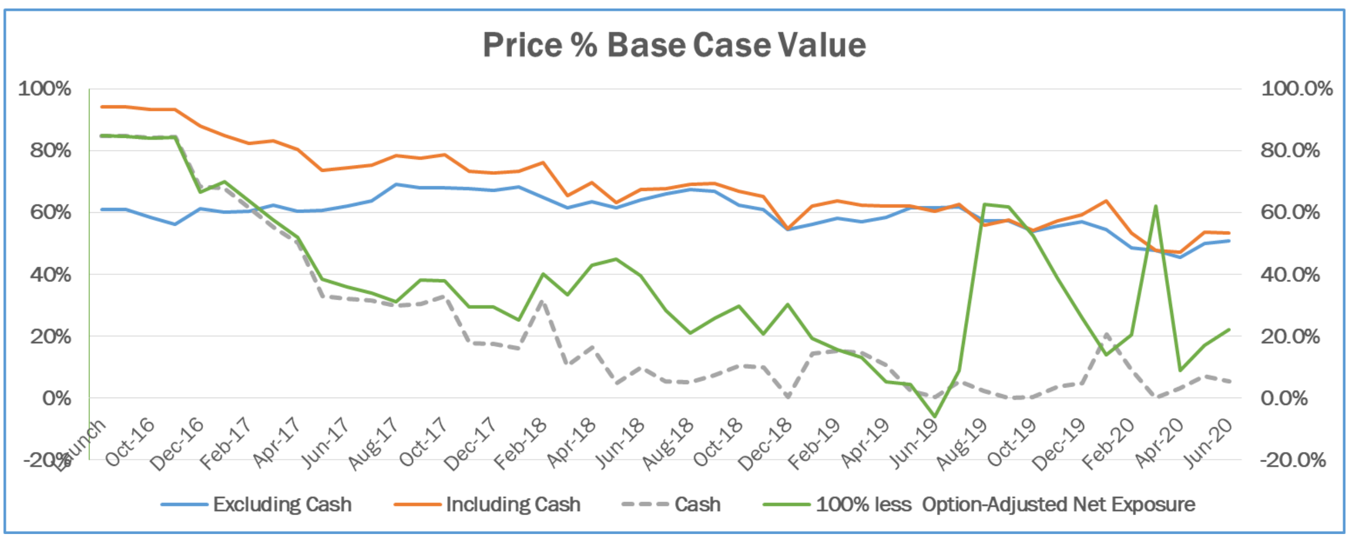
Where does that leave us? Value investing, properly understood and implemented is still likely to lead to large outsized excess returns. However, a much smaller percentage of practitioners will be able to achieve this outcome than had in the past, and many investors following a more mechanical approach or subverting the ideas of value investing to stray too far from its real tenets are likely to do no better than the market over time net of fees and expenses.

Portfolio Metrics

I track a number of metrics for the portfolio to help me better understand it and manage risk. I track these both at a given point in time, and as a time series to analyze how the portfolio has changed over time to make sure that it is invested in the way that I intend for it to be. Below I share a number of these metrics, what each means, and what it can tell us about the portfolio. As time passes, you should be able to refer to these charts and graphs to help you gain deeper insight into how I am applying my process.

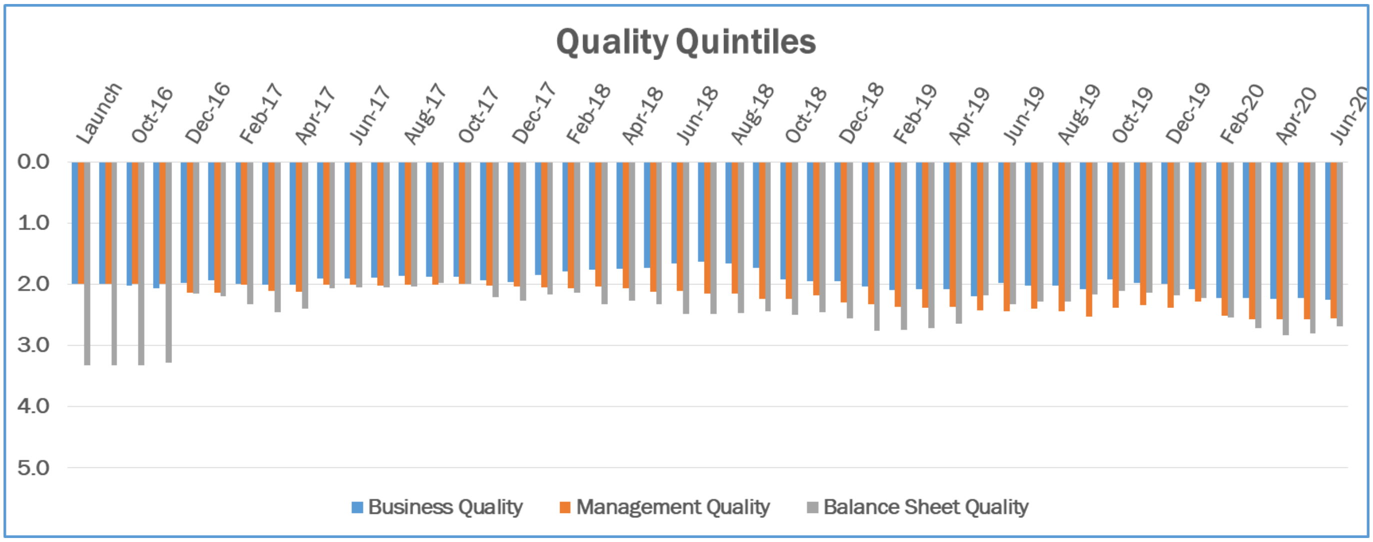
Price % Base Case Value

This metric tracks the portfolio's weighted average ratio between market price and my Base Case intrinsic value estimate of each security. This ratio is presented both including cash and equivalents, which are valued at a Price to Value of 100%, and excluding those. All else being equal, the lower these numbers are, the better. Excluding cash and equivalents, a level above 100% would be a red flag, indicating that the portfolio is trading above my estimate of intrinsic value. Levels between 90% and 100% I would characterize as a yellow flag, suggesting that the portfolio is very close to my estimate of value. Levels between 75% and 90% are lukewarm, while levels below 75% are attractive.



Quality Quintiles

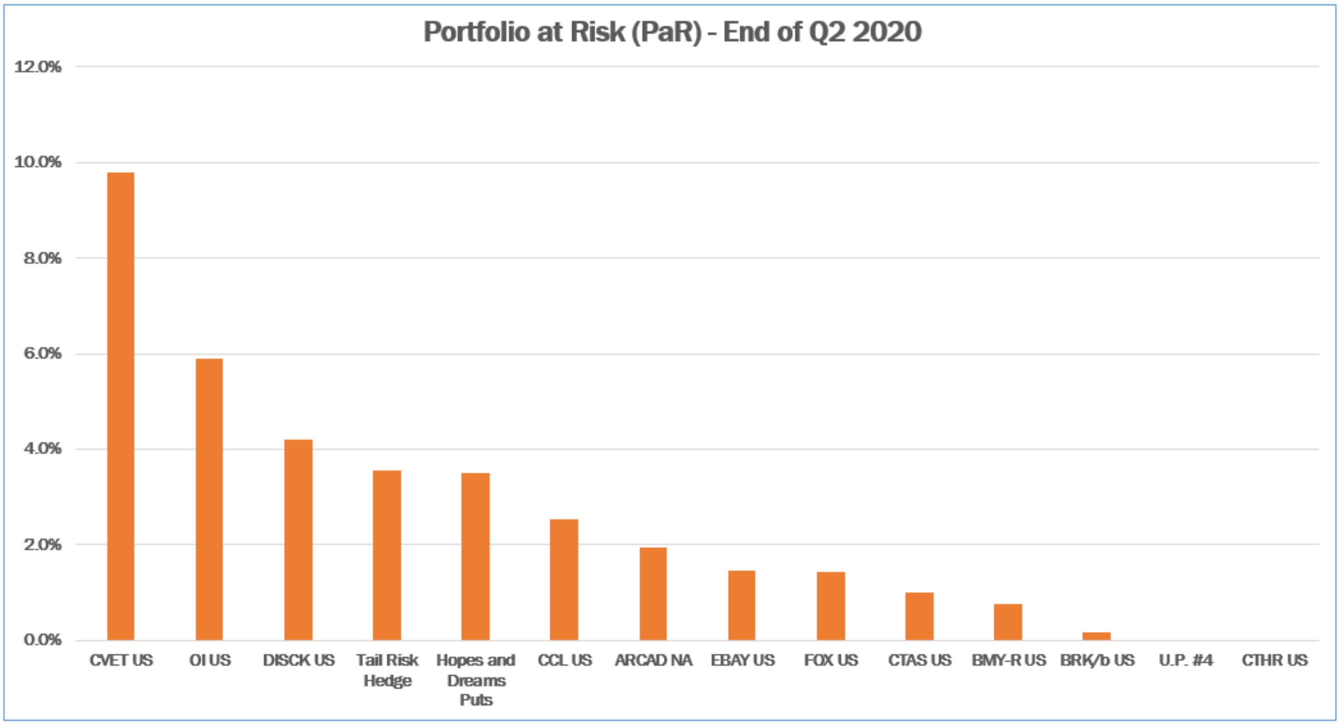
As outlined in the Owner's Manual, I evaluate the quality of the Business, the Management and the Balance Sheet as part of my assessment of each company. I grade each on a 5-point scale with 1 meaning Excellent, 2 Above Average, 3 Average, 4 Below Average and 5 Terrible. The chart that follows presents the weighted average for each of the three metrics for the securities in the portfolio.



Portfolio at Risk (PaR)

I estimate the Portfolio at Risk (PaR) of each position by multiplying the weight of each position in the portfolio by the percent downside from the current price to the Worst Case estimate of intrinsic value. This helps me manage the risk of permanent capital loss and size positions appropriately, so that no single security can cause such a material permanent capital loss that the rest of the portfolio, at reasonable rates of return, would not be able to overcome. I typically size positions at purchase to have PaR levels of 5% or lower, and a PaR value of 10% or more at any time would be a red flag. The chart below depicts the PaR values for the securities in the portfolio as of the end of the quarter.

Note: Positions are presented including options when applicable. So for example, the Owens-Illinois position includes the impact of the hedge (put options).



Note: ***In cases where the Downside to Worst Case < 0%, PaR = 0%***

Normalized Price-to-Earnings (P/E) Ratio

I supplement my intrinsic value estimates, which are based on Discounted Cash Flow (DCF) analysis, with a number of other metrics that I use to make sure that my value estimates make sense. One of the more useful ones is the Normalized P/E ratio. The denominator is my estimate of earnings over the next 12 months, adjusted for any one-time/unsustainable factors, and if necessary adjusted for the cyclical nature of the business to reflect a mid-cycle economic environment. The numerator is adjusted for any excess assets (e.g. excess cash) not used to generate my estimate of normalized earnings. One way to interpret this number is that its inverse represents the rate of return we would receive on our purchase price if earnings remained permanently flat. So a normalized P/E of 10x would be consistent with an expectation of a 10% return. While the future is uncertain, it is typically my goal to invest in businesses whose value is increasing over time. If I am correct in my analysis, our return should exceed the inverse of the normalized P/E ratio over a long period of time. The graph below represents the weighted average normalized P/E for the equities in the portfolio.

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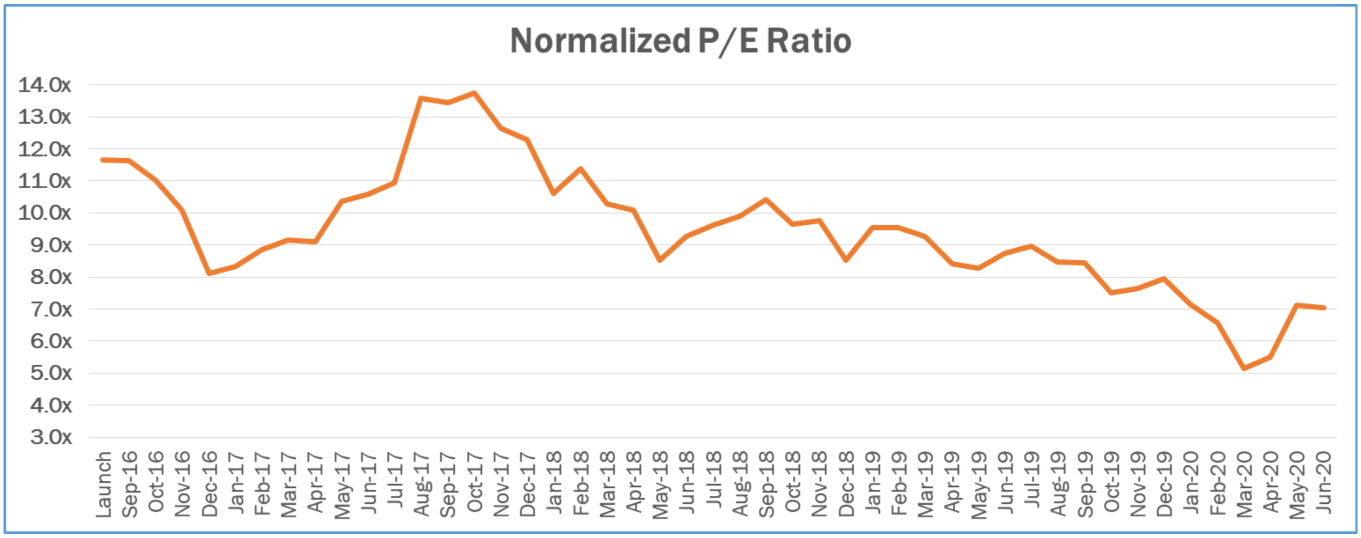

Conclusion

There were 3 small things that I observed in mid to late June that made me think that **the stock market is acting a little crazy**:

- The stock price of Hertz (HTZ), a company that had just filed for bankruptcy protection, temporarily **traded *above* the pre-bankruptcy price** as retail speculators bid up the stock. Meanwhile, institutional investors in the Credit Default Swaps (CDS) market were pricing CDS protection in a way that implied a less than 50% recovery for the *bonds.*

  Hertz's management, rationally from the narrow perspective of doing the best for their current stock and bond holders, quickly rushed to issue new shares, despite being in bankruptcy, to take advantage of the victims… err.. retail investors. Unfortunately for Hertz, this was too much even for this SEC, which put the kibosh on that plan.
- The now infamous FANG+ stocks have been on a tear lately (and during the last decade). A bit late to the party, retail investors wanted in on this risk-free way to make quick profits. They spied what they thought was a FANG-related ETF. Unfortunately for them, this was just a Chinese company listed on the U.S. exchange that had a name vaguely reminiscent of FANG. The speculators within the span of *hours* bid up this illiquid stock by *10x*, taking the market cap from hundreds of millions to billions.
- The U.S. stock market, as measured by the S&P 500, almost came back to its level at the beginning of the year, which was already quite high. This is despite massive economic damage that has been done, and a still wide range of future economic outcomes. If most people were told all the facts known now on January 1st, few would have guessed such a benign outcome. There are many after-the fact rationalizations for why this makes sense (the Fed, rapid growth off a low base, the worst is behind us, etc). I will leave it to you to decide how rational you think this is.

One silver lining of this crisis is that I have been able to spend more time with my children. My 7 year old twins are still too scared to watch grown up movies like *The Hobbit* and *Lord of the Rings*. Not so my youngest, Jacob, who is only three and a half. He and I, over the course of weeks, watched all 6 movies. A scene from the first movie of The Hobbit summarizes this market well.

One of the main protagonists, the wizard Gandalf, brings several pieces of circumstantial evidence that great evil may be stirring again to the wisest of his order, Saruman, the leader of the elves, Lord Elrond and the Queen of the Woodland Elves, Lady Galadriel.

> Saruman: *What Enemy? The Enemy is defeated. Sauron is vanquished. He can never regain his full strength.*
>
> Lord Elrond*: Gandalf, for 400 years we have lived in peace. A hard-won, watchful peace.*
>
> Gandalf: ***Are we at peace?*** *Trolls have come down from the mountains. They are raiding villages, destroying farms. Orcs have attacked us on the run..*

Lord Elrond: *Hardly a prelude to war.*

Saruman: *Always you must meddle. Looking for trouble where none exists!*

Gandalf: *There is something at work beyond the evil of Smaug. Something far more powerful. We can remain blind to it, but it will not be ignoring us, that I can promise you! A sickness lies over the Greenwood. Woodsmen there now call it Mirkwood. They say… they speak of a necromancer living in Dol Guldur. A sorcerer that can summon the dead.*

Saruman: *That's absurd. No such power exists in this world. This "necromancer" is nothing more than a mortal man. A conjurer dabbling in black magic…*

[Gandalf puts an object rolled up in a leather skin on the table]

Lord Elrond: *What is that??*

Lady Galadriel: *A relic of Mordor!*

Lord Elrond: *A Morgul Blade!*

Lady Galadriel: *Made for the Witch King of Angmar. And buried with him… When Angmar fell, Men of the North took his body, and all that he possessed and sealed it within the High Fells of Rhudaur. Deep within the rock they buried him… in a tomb so dark it would never come to light.*

Lord Elrond: *This is not possible. A powerful spell lies upon those tombs. They cannot be opened.*

Saruman*:* What proof do we have that this weapon came from Angmar's grave?

Gandalf: *I have none…*

Saruman: *Because there is none! Let us examine what we know. A single Orc pack has dared to cross the Bruinen. A dagger from a bygone age has been found. And a human sorcerer who calls himself "The Necromancer" has taken up residence in a ruined fortress. It's not so very much after all.*

Whether intentionally or not, Tolkien has his characters display an array of **behavioral biases.** The elders to whom Gandalf brings his circumstantial evidence are *anchored* on a reality that they favor – one in which there is no existential danger. That feeds into their *confirmation bias* which causes them to reject disconfirming evidence or interpret it in a way that supports their initial hypothesis on which they are anchored. Evidence to the contrary is not proof that they are wrong, since that is impossible as they already *know that* they are right. Therefore it is *the evidence* that must be wrong. In a logical contortion driven by their biases, absence of proof becomes proof of absence.

I am no stock market analyst – I am a bottom-up security analyst. I do not know what the markets will do this quarter or this year. However, two decades of professional value investing experience and a study of many decades prior to that tells me that **right now is a time to be very cautious** and only make investment commitments which meet a high degree of margin of safety. I will let you reach your own conclusions as to whether we are, as Gandalf puts it, "at peace" in the stock market, or not.

I am happy to answer any questions you have. Your feedback is important to me; please let me know how I can improve future letters. I greatly appreciate your trust and support, and I continue to work diligently to invest our capital.

Sincerely,

Gary Mishuris

Gary Mishuris, CFA
Managing Partner, Chief Investment Officer
Silver Ring Value Partners Limited Partnership

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