July 7, 2016

2016 1st Half Shareholder Letter

Period	Wiedower Capital	Russell 2000	Difference
2015*	-9.49%	-6.62%	-2.87%
2016 1st Half	20.10%	2.21%	17.89%
Cumulative	8.71%	-4.56%	13.27%
CAGR	6.39%	-3.40%	9.79%

* Started trading February 24, 2015. Results are net of fees.

Wiedower Capital has now been active just over 16 months and in total, we've outperformed the Russell 2000 by 13.27%, net of fees. While that is a good start, 16 months is far from a long enough time period to make any meaningful conclusions. My goal is to outperform stock market indexes over periods of at least three years; even one year results are not too meaningful in the investing world. I want to start this letter by giving updates on three positions I discussed in my last letter and then introduce two new positions we've taken this year.

Updates

At yearend 2015, LGI Homes (LGIH) and Consolidated-Tomoka (CTO) were our two largest positions. LGI had collapsed 35% in December because of what I believed were a handful of overblown news headlines. That statement now appears to be quite prescient as LGI has regained almost all of that in 2016. On this rally we've started to shave our position some. I think LGI is still undervalued, but not nearly as much as when we bought in last summer. Fortunately I've been finding other interesting opportunities lately so this position will continue to be cut as I raise cash for other investments with better risk/reward ratios.

Not much has changed with Consolidated-Tomoka in the past six months. If you remember, a hedge fund manager owning 26% of shares essentially forced the company to put itself up for sale. This process is still ongoing and the stock price seems to be forever languishing until the next update. Often these situations consist of many months of silence only for an acquisition to be announced out of nowhere and the stock to spike in one day. Hopefully that day is sooner rather than later. The next announcement from management should be towards the end of this month so we might learn more then.

Finally, Xpel Technologies (DAP.U) was a small position at the end of 2015 that had a patent infringement lawsuit filed against them on December 30th. After researching the lawsuit a lot more (including hiring a patent agent to work with me), I concluded the risk was too high and we sold our entire position. While uncertain situations often create opportunity, I think there is a realistic chance this lawsuit crushes Xpel. At the very least, it's going to cost them a lot of money (which they don't have a ton of) and several years to defend themselves. If you're interested in a much more detailed analysis, I posted a two-part series on my blog covering all my thoughts. You can read both entries at traviswiedower.com.

New positions

During the first six months of 2016, we've started two new sizable positions—Armanino Foods (AMNF) and Interactive Brokers (IBKR). Each position is 6-7% of assets under management. While these two companies couldn't be much more different, they do have a couple commonalities. First is their ability to thrive during downturns. The current bull market is the second longest in history so it'll probably be coming to an end sooner rather than later. That of course is not reason enough to buy a stock, but it's a nice-to-have at this point in the cycle. Both Armanino and Interactive Brokers performed well during the financial collapse.

In addition, both of these companies have durable business models that should be around ten or twenty years down the line. I've been thinking and reading a lot about technology this year. We're in the early innings of a massive technology boom, and while that excites me as an individual, as an investor it scares the hell out of me. Whether it's self-driving cars, artificial intelligence, graphene, renewable energy, or personal drones (or a thousand other things), it's inevitable that advanced technology is going to change the world in a major way in the coming decades. A lot of perfectly good companies will go the way of the do-do bird in the not-too-distance future. My job is to think about a future that looks quite a bit different than the present and find companies that will survive and thrive in that environment. In my opinion, both Armanino Foods and Interactive Brokers fit that bill.

Armanino Foods

Armanino sells frozen pestos and other Italian items to restaurants and grocery stores. This is a relatively simple business that can last a long time once a company gets the grocery store shelf space and brand recognition (which Armanino has). While there are some advancements in food that may change the industry (Soylent is one possible food alternative if you're interested), I don't see our basic culture of eating changing anytime soon. Vertical farming is another new technology in the food world that is just beginning. This is the practice of growing food in vertically stacked layers in climate-controlled warehouses. There are some side effects that need to be solved before this scales, but the advantages seem well worth it—massively increased productivity from a given surface area, less water required for more yield, the ability to grow crops year around anywhere in the world, no crops destroyed from weather, and conserving land that can be harmed from over-farming. With all that said, I don't think this is a risk to Armanino. If anything, vertical farming will reduce the input costs of their products.

As for my investment thesis, I won't bore you with unnecessary details because it's really quite simple. In 2015 and throughout 2016, Armanino has spent a lot of money to expand manufacturing capacity to handle new, large clients. In addition, they have a line of credit that will be fully paid off in early 2017. These are two large sources of cash drain that will be finished in less than a year. After that, Armanino will be producing much more cash than they are currently, especially when considering the expected revenue growth from those new clients. I think the market is underestimating how much cash Armanino can generate in 2017 and beyond. Historically, they have paid out most of their excess cash as dividends so I expect that's where a lot of their newfound cash will go. I believe they'll generate enough cash in 2017 to pay out around $0.13-$0.15 per share in dividends. At a 4% dividend yield that'd equate to a stock price around $3.50, over 60% higher than today's price. That's quite a return in just a year and a half. Let's hope I'm at least in the ballpark of being correct.

Interactive Brokers

As I'm sure you recognize the name as Wiedower Capital's broker-dealer, Interactive Brokers is an electronic broker focused on sophisticated investors (hedge funds, RIAs, professional traders, etc). You may notice that Interactive Brokers is by far the largest company we own and definitely outside of the small and micro-cap universe I ascribe to. If you looked up Interactive Brokers online you'd see a market cap of just under $14 billion, but the float is far less than that. Only 15.7% of company shares are publicly held (the rest are mostly owned by the CEO) so the float is closer to $2.2 billion. Because of this, Interactive Brokers has less volume and gets much less Wall Street attention than its market cap would suggest (good for us). While not a true small cap, it certainly acts like one given its float.

I normally avoid companies with a majority owner because it's too easy for that person to take advantage of shareholders, but their founder and CEO, Thomas Peterffy, is an exception. Peterffy founded this company in 1977 with the current brokerage business beginning in 1993 and Interactive Brokers going public in 2007. This means there is a lot of information out there about Peterffy and there's been ten years as a public company proving he's shareholder friendly. But more than anything, he is hell bent on making Wall Street far more automated and efficient than it is today. He hates how inefficient the big banks are and he hates how many misaligned incentives there are in this industry. Two of his main gripes are brokers that sell their customer orders to high frequency traders who then trade against those very same orders (all the Scottrades of the world do this) and likewise, the big banks that trade against their own customer orders via dark pools. Peterffy has written many letters to the SEC over the years imploring them to make the markets more fair. Long story short, I've seen enough evidence that Peterffy is obsessed with making Interactive Brokers the biggest broker in the world and he's proven to be shareholder friendly.

Like Peterffy, I believe it is inevitable that Wall Street becomes much more efficient, automated, and electronic over the coming decades. Technology is going to force this fate upon most industries and Wall Street is no different. Fortunately, Interactive Brokers has a large technological lead on everyone else in the industry. Having the best technology gives them the ability to charge the lowest fees while maintaining the highest margins. Think about that: they charge the lowest prices and they still have the highest margins. That's incredible. And having the lowest fees attracts new customers who then generate more revenue for them. Finally, this increased revenue means they have more money to improve their technology and the cycle starts over. Once a flywheel like this begins it is very difficult for a competitor to stop it. This is one reason I don't think their competitors will catch up to what they offer.

Peterffy describes Interactive Brokers as more of a technology company than a Wall Street broker. This is because all their top executives (including Peterffy) are programmers and over 50% of employees are programmers. It's in their DNA. The DNA of the retail brokers (like Scottrade) and the big banks (like Goldman Sachs) is sales. And sales has absolutely worked in the past, but the best technology will win the future (as it's already started to). Eventually the most money will want to be invested where there are the fewest frictional expenses, and that place is where the best technology has ousted the unnecessary overhead.

Closing remarks

At period end, we had close to 100% of funds invested in 12 stocks. As a few of our stocks are approaching my estimate of fair value, I will be downsizing several positions in the coming weeks and months. Several of our newer stocks can be quite volatile so I'd like to have 10-20% cash to take advantage of temporary drops. Holding a little more cash in this market environment (as discussed above) is probably the prudent thing to do as well. If you have questions about any of our positions, please let me know. Next you'll hear from me will be January 2017. Cheers.

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