IBV CAPITAL

2015 Semi-Annual Partnership Letter
July 2015

Dear Partners,

The first half of 2015 was a period that required us to be patient, disciplined, and focused. As always, there are many investment options available to us - tens of thousands of them - however, in today's market environment, we think it's prudent to be extremely selective. While the level of activity in our portfolio remained low, behind the scenes we conducted in-depth research on numerous companies that we think very highly of, but ultimately could not justify purchasing them at their current valuations. This is a common occurrence and one you can expect to continue. We are prepared to be tremendously patient, and are simply not willing to invest your capital - or ours - unless we find the right investment at the right price.

In the last six months, we purchased a select few attractive investments, but before I uncover them, I would like to look at our portfolio as a whole. When we see our portfolio, we see a conglomerate, with each individual security representing a distinct business unit. We take this approach for two reasons: one, it helps us uncover how our individual securities (read business units) interact with each other on a business level, and secondly, by viewing the portfolio as a conglomerate, we can compare its value to that of the marketplace. As shown below, relative to commonly followed global index multiples, our portfolio trades at a steep discount:

	IBV Capital	MSCI World	S&P 500	IBV Upside
Price/Earnings	10.8x	18.2x	19.0x	69% - 76%
Price/Cash Flow	8.3x	10.6x	11.7x	28% - 41%
Price/Book	1.1x	2.2x	2.8x	100% - 155%
Price/Sales	0.9x	1.5x	1.8x	67% - 100%

In last year's annual letter, I wrote about the market valuation levels that existed as we entered 2015. Since then, not much has changed. Today, the MSCI and S&P 500 trade at multiples that significantly exceed their long-term historical averages. As a general rule, we avoid owning companies when their valuations are exceedingly high. This is why our combined portfolio usually enjoys valuation levels that are below historical averages. At present, if our companies were to trade in line with the indices above, they would experience between a 28% and 155% gain in value.

We often cite our approach to risk and how it relates to returns. In the case of our portfolio, the probability that our positions lose permanent value from today's levels is greatly reduced as a direct result of the low prices we have purchased them at. At the same time, the return potential that could be realized if our positions begin trading closer to market levels, is highly attractive. This dynamic precisely illustrates why we don't need to take greater risks to earn greater returns.

For Partners that were with us for the entire first half of 2015, our performance was -0.9%. This compares to a 2.6% and 1.2% gain by the MSCI World Index and S&P 500 Total Return Index, respectively. While we're benchmark agnostic, we like to provide our Partners with perspective into how their investment with us is performing relative to other options. Considering the companies we own and the valuations they trade at, we believe that we are extremely well-positioned for any future market environment.

Important, But Unknowable

You have likely experienced trying to merge onto a highway when an 18-wheeler is in the next lane. At first, the truck doesn't appear to be there, but suddenly, it is. This is problematic. As your lane comes to an end, your mind usually begins considering the possibilities. Perhaps you'll have to completely stop or maybe you consider a much worse outcome. As is often the case, the truck will pass, you will merge, and a few minutes later, you will return to enjoying your music. The timeframe is longer, but in financial terms, Greece represents the 18-wheeler. A decade ago, Greece wasn't an issue. Five years ago, it became a problem. Today, it carries an air of catastrophe. In due time, this events' importance will diminish, and the financial world will move on.

We have been faced with similar situations before. Some were more abrupt and impactful than others. When the world went to sleep on Sunday, October 18, 1987, no one ever expected to see the Dow Jones Industrial Average fall by 508 points or 22.6% the next day - Black Monday. Today, China's stock market is experiencing its version of 'Black Monday,' only in a slightly more drawn-out form, and I'm sure few need to be reminded of the recent Financial Crisis. Mark Twain couldn't have been more right when he said – "History does not repeat itself, but it rhymes."

We are enthusiastic students of financial history, which means we understand that it's not a question of if similar events will occur, but when. Exactly when is completely unknown. That's why we take measures to protect ourselves from these events while at the same time putting ourselves in a position to capitalize on them. The particular measures we consistently use include: investing with a long term perspective, buying only when a substantial margin of safety exists, and at times, holding a meaningful cash position. How much cash is appropriate to have within a portfolio? We have a framework that helps us answer this question.

Cash, an Option on Opportunity

Most professionally managed portfolios hold very little cash. Why? Well, some think that their clients have hired them to invest their money, instead of merely holding onto it. Other managers perceive cash only to be a drag on investment performance. It's this perception that I would like to focus on because we have a very different perspective. As we see it, cash protects us from the financial impacts of tumultuous times while simultaneously positioning us to be able to opportunistically capitalize on them. We think cash is a very valuable tool. Exactly *how valuable* is a difficult thing to precisely measure. However, within our framework, we do work towards quantifying this by breaking down the value contribution of cash into three components: Interest, Inflation, and Optionality.

<u>Interest:</u> Today, one-year US Government Bonds yield 0.28%, whereas over the last 20 years, it has averaged 2.76%. Obviously interest rates can change considerably over time, but day-to-day, they change by relatively small increments. For the purpose of determining the current value contribution of cash, interest is usually additive and essentially static.

<u>Inflation</u>*:* Paul Volcker, during his term as Federal Reserve Chairman (1979-1987), increased interest rates to foster price stability. The Federal Reserve has continued their pursuit of price stability in the form of an inflation rate target, which stands at 2.0%. Today, inflation is 1.7%. Going forward, we anticipate this target will help keep longer term inflation expectations firmly anchored. Inflation acts as a direct, but relatively stable, offset to the value generated from interest being earned on cash.

<u>Optionality:</u> Interestingly, the idea of optionality is derived from the most basic investing principal. You should buy low and sell high. Assuming this principal is true – and it is – we can conclude that if you pay a low price for a security, you should expect to experience a better return than if you pay a high price for it. It also implies that if you fail to invest when a security's price is low, you may miss

out on very attractive returns. We interpret this to also mean that cash can be a meaningful drag on future performance when securities prices are low. On the other hand, by investing when a security's price is high, you're less likely to make a good return, if any return at all, and the risk of a loss has increased considerably. Here, in this scenario, we can conclude that cash will be much less of a drag on future performance and instead act like a protective cushion for when prices eventually fall. The value of the optionality cash gives you is difficult to pinpoint, but it's there and it's significant.

Today, in our eyes, market values are high and we see very few interesting opportunities. This is why we hold more cash than usual. When market values return to attractive levels – and they always do – we can return to prudently deploying more of our cash.

<u>When Greece Gives You Olives, Make Olive Oil</u>

During the first half of 2015, we added two meaningful positions. New to our portfolio is Bank of America and Citigroup. Our portfolio now consists of three US banks, and combined, they represent 18.8% of our holdings.

We are very familiar with both Bank of America and Citigroup. In late 2011, Greece was "*leaving the Euro*" for the first time, and the US was thought to be entering a second recession. Both these institutions, who had weathered far more uncertainty (to put it mildly) during the Financial Crisis, were trading at unreasonable levels relative to their book values and long-term earning capabilities. At the time, I felt Bank of America and Citigroup would be ideal long-term investments and began purchasing their shares aggressively. Now, with Greece "*leaving the Euro*" for the third time, and the US economy on much more stable footing, we find ourselves drawn to both banks once again.

Since the Financial Crisis, much has changed. Personal and business credit conditions have improved considerably. Lending standards have also tightened, to the extent that some argue they are stifling US economic growth. For Bank of America and Citigroup, these conditions, having been in place for a number of years, provide us with comfort that the quality of their loan books have greatly improved. This comfort is being confirmed by the improved credit quality statistics they both have been reporting as of late.

The Financial Crisis prompted many regulatory changes, many of which are both complex and costly to implement. Many of today's new regulations focus on capital requirements, liquidity, and risk-control mechanisms. Both institutions hold more high-quality capital on their balance sheets than they did before entering the Financial Crisis. At the end of 2014, Bank of America and Citigroup held 10.7% and 10.9% of common equity against their total assets, respectively. This is the highest level of common equity either firm has held going back to 2000. Their liquidity positions have also been enhanced. More capital and greater liquidity, combined with the enormous cost of implementing these regulations is, to some extent, creating a drag on earnings growth. However, we feel these balance sheet enhancements, especially during times of distress, will serve both these institutions well. Furthermore, underwriting controls, while exceedingly lax just a decade ago, have also vastly improved. Today, we see very few widespread problematic debt underwriting practices and plenty of focus on ensuring another Financial Crisis will not happen again any time soon.

Citigroup, like many financial institutions during the Financial Crisis, held large pools of poorly performing loans. To enhance reporting transparency, Citigroup isolated their problematic loans by placing them into a self-designated 'bad bank' known as Citi Holdings. At the time of its creation, Citi Holdings had a considerable impact on Citigroup's overall financial performance. This influence has waned over the years. Recently, Citi Holdings represented just 6.3% of the company's balance sheet, down from 40.6% at the end of 2007. Its influence on earnings has equally diminished, allowing the fundamentals of Citigroup's other business units to shine through. The gem we are dazzled by is the potential of their sizable and highly profitable consumer credit card franchise. Cards represent only 7.3% of Citi's assets, but 26.0% of trailing twelve months income from continuing operations (when we exclude Citi Holding's losses). An improving economic and credit environment are ideal conditions for this specific line of lending to thrive.

We're also intrigued by Citi's global reach because we think it will contribute meaningfully to future growth. Their ownership of Banamex, Mexico's second largest bank, is one particularly attractive prospect. While global reach has its benefits, it can also create difficulties. Even Banamex recently experienced a risk-control breakdown in their lending practice, a situation which was quickly addressed. Michael Corbat, Citigroup's CEO, has also identified 11 non-core markets that will be closed and their resources re-allocated to more profitable endeavours, which is a practice we applaud.

In March, the Federal Reserve Board conducted its annual bank stress and capital adequacy test, known as the Comprehensive Capital Analysis and Review ('CCAR'). The outcome of this test determines if the Federal Reserve will allow each submitting bank to proceed with its capital planning initiatives, including issuing dividends and conducting share buybacks. This year Citi passed the test with some terrific results. Considering the troubles this organization encountered during previous testing rounds, this was quite an accomplishment. Clearly, their focus on improving risk-control mechanisms along with enhanced capital levels is gaining traction with regulators. With the ability to return even more capital to shareholders, particularly by way of buybacks, we stand to benefit immensely.

Bank of America is the 2nd largest US financial institution and enjoys considerable competitive advantages as a result. Their deposit base is highly diversified and provides them with a continuous stream of ultra-cheap capital. Unfortunately, they have been unable to deploy this capital at attractive lending rates as a result of the highly accommodative Federal Reserve interest rate policy - a problem many of today's banks are facing. We believe this is about to change. Further fueling their growth will be the bank's close ties to the US housing market, which has shown sustained improvements.

For Brian Moynihan, CEO of Bank of America, the 2015 CCAR test was a challenge. The bank passed, but only conditionally. Having watched Citigroup experience similar troubles in 2014, he is taking a page from their playbook and focusing intensely on unconditionally passing next year's test. It's important they pass and commence share buybacks. At these valuation levels, any buybacks will be highly accretive to the remaining shareholders.

For both banks, while the additional capital and liquidity will improve stability, they will also make it more difficult to earn high returns on assets and equity. I anticipate these headwinds to be offset by improving US growth prospects, lower operating expenses, and a controlled rising interest rate environment. Also, an abrupt slow-down in the legal expenses and impairments experienced in the past few years will be quite meaningful to their bottom lines. Since 2008, Bank of America absorbed $37.0B in litigation expenses and $15.6B in impairment charges. Combined, these costs amount to 35.8% of their pre-crises shareholder equity levels. At Citigroup, they incurred $16.5B in legal related fees and experienced $15.2B in impairments. This represented 27.9% of their 2007 equity levels. These charges have destroyed a lot of shareholder value, but now that the vast majority of them have passed, both company's true earnings power will begin to shine through.

The individual attributes of both these banks have us feeling very positive about their long-term potential. We really like the strategy Brian Moynihan is executing at Bank of America. His focus on selling more products to existing clients will strengthen their customer relationships and drive organic growth. We see Michael Corbat's efforts enhancing Citigroup's risk controls, paring costs, and refocusing on core-markets and products, benefitting their bottom line in a meaningful way.

Increased economic activity is conducive to a robust loan growth environment. It also helps improve the financial condition of their clients, which in turn improves the underlying credit quality of existing loans. There are clear indications that this is happening at both banks. While we don't know when the Federal Reserve will increase interest rates, we are confident that they will. This will become yet another revenue driver. There are a lot of positive factors for both Bank of America and Citigroup and we expect to benefit handsomely from them.

IBV Capital

We have added an important member to our executive team, Deven Bhalla. Deven brings over seven years of investor relations and business development experience in the financial services industry to our team. As Vice President of Business Development, he will focus exclusively on providing our Partners with complete investment transparency and to work with IBV's growing network to foster new relationships. With Deven offering such a high level of support to existing and new Partners, I'm now able to focus even more of my time doing what I enjoy most - managing our portfolio.

I truly appreciate your investment with IBV Capital. Should you have any questions or if I have not been clear in any respect, I would be very happy to hear from you.

Sincerely,

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