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Letter to Investors: 2016 Review

Dear Investment Partner:

For the full year 2016, the Saber Capital Management portfolio* gained 23.8% gross (and 19.4% net of all fees). The S&P 500 gained 12.0% including dividends in 2016.

Your Interactive Brokers account statements should have arrived in the mail. Those statements contain your 4th quarter results as well as the current positions and account value as of 12/31/16. You can see your yearly results as well as other relevant details for your account online on your Account Management page at Interactive Brokers. Please contact me with any questions regarding your account.

Performance Comments—It's a Marathon

Regarding our performance in 2016, I want issue a reminder that I really place very little weight on any one year's results. Our results this year exceeded the return of our opponent (the S&P 500), but my expectation is that this variance could be much greater in future one-year periods, both in the positive or the negative direction. I consider results in one year to be more or less random, and our performance measuring tools should always be calibrated for multi-year periods.

Investing is a marathon, and each year can be thought of as just one mile marker along the route. Some years will feel like Heartbreak Hill, the grueling 21st mile of the Boston Marathon, while other years will be more akin to the 2nd mile in New York, where, from the crest of the Verrazano-Narrows Bridge, you glide downhill all the way into Brooklyn.

We should all fully expect to have our fair share of both uphill and downhill years, but to complete a marathon you first must concentrate on the pavement in front of you, putting one foot in front of the other. That's what I'm fully focused on each day when I come into the office. I hope and expect that by adhering to our investment process regardless of the current terrain, excellent long-term results will follow over time, and I hope to be judged not on each mile split, but over the full 26.2 mile course.

Our investment approach is squarely focused on producing the best possible long-term results with a minimum of risk. This involves an unconventional (but—I firmly believe—less risky) approach to portfolio management. The byproduct of this approach can lead to results that vary much more widely than the market in any given year.

Of course, I'd prefer our results to always vary widely in the positive direction, but unfortunately, the market gods didn't design their stock market universe with my wishes in mind. Human nature and the impact it has on markets creates volatility, which can be a tool that we use to our advantage rather than an obstacle that we attempt to avoid. As Ben Graham said, Mr. Market can be our servant or our master. I've always liked being my own boss, and so on behalf of all of us, I'll choose the former.

Saber Capital Investment Approach

Every so often, it's helpful to outline Saber's basic philosophy. Since we have a number of new investors who have yet to be indoctrinated, I thought it would be a good time to make a few comments on our approach.

Saber's investment strategy focuses on making carefully selected investments in high-quality businesses at attractive prices. This ubiquitous description of a well-trafficked investment philosophy does not take away from the soundness of the approach, nor does it compromise our ability to capitalize on its merits, for two main reasons that I'll describe below.

Some of the key tenets to my investment approach are:

- Understanding the business model and how the company makes money
- Considering the value that customers place on the company's product or service
- Focusing on durable businesses with predictable cash flow
- Preferring a management team that thinks and acts like owners
- Demanding an obvious gap between price and value (margin of safety)

When it comes to stocks, simplicity and common sense work well. I try to focus on restricting our investments to companies that implement a business model that makes sense to me. I want to not only understand how the company makes money, but I want to understand the value proposition it offers its customers. Good businesses have good economics such as high returns on invested capital and consistent free cash flow, but they also provide a product or service that offers value to the buyer on the other end of the transaction (the customer).

As I've learned over the past few years watching debacles such as [Valeant](#) and [SunEdison](#), a business with good economics that is coupled with a business model that extracts value from its customers (rather than adds value to its customers) is not a good business. The financial metrics might appear attractive, but a parasitic relationship with customers usually ends up destroying shareholder value at some point. So guarding against this type of business risk is a major focal point at Saber.

Also, while my twin two-year olds would quickly challenge this assertion, sleeping well at night is a must, and so I like businesses with strong balance sheets and preferably without much debt.

And since my economic crystal ball has never worked well, I look for durable businesses that can withstand a variety of economic headwinds, which are certain to occur over time.

Two Important Advantages (Our “Edge”)

Finally, I believe there are two requirements in order to implement this approach successfully:

- Maintaining a long-term time horizon
- Focusing on only the very best investment ideas

Both principles are often preached, but very rarely practiced. Institutional constraints and good old fashioned human nature can make it very difficult to actually utilize those two advantages. This difficulty is the reason the advantages exist, and I believe—since human nature is here to stay for a while—these advantages are permanent for those who can capitalize on them.

The Long-Term Advantage

The first is to maintain a long-term time horizon, which I believe is now a bigger advantage than ever. Fifty years ago, the average stock was held for 14 years—today it is disposed of after about 11 months. The short-termism that is pervasive in the stock market creates lots of irrational buying and selling for all sorts of reasons that have everything to do with the short-term direction of the stock, but nothing to do with long-term value of the business. By the very nature of the ever increasing focus on the next quarter, I believe this long-term mindset—when actually implemented—is a sustainable advantage, and one that is likely to strengthen over time.

Technological innovations over the years have vastly increased the breadth of available information, the speed at which the information travels, and the ease with which that information can be obtained. With so much human and physical capital spent on trying to gain an information advantage, it’s best to bypass that short-term focus completely, and quietly consider the bigger picture. This helps identify the key variables that really matter, and those variables are rarely the consensus estimates for next quarter’s EPS or the decimal-point accuracy of the gross margins.

Predicting an acquisition based by tracking the cities that an acquirer’s executive airplane travels to, or using satellite imagery to track the number of cars in a retailer’s parking lot to better predict this quarter’s revenue numbers (two things hedge funds have done recently to try and gain an information advantage) is not a game that I can (or desire) to play. But the fact that so many resources are focused on competing in this short-term arena leaves an opportunity for those who can look out past the noise and think about the situation from a different view.

Capitalizing on others’ desire to avoid volatility is what makes this strategy work. Dealing with this interim volatility is the price of admission, but it’s more than a fair trade.

Waiting for Great Ideas

“I just wait until there is money lying in the corner, and all I have to do is go over there and pick it up.” – Jim Rogers

I’ve always felt that Rogers, who helped build the foundation for one of the greatest investment track records in history during the 60’s and 70’s, perfectly encapsulates this second main pillar of my investment approach: **do nothing until there is something really obvious to do.**

Charlie Munger said that it isn't possible for humans to know "everything all the time". But, he said, it is possible to occasionally find something of value. When that happens, it's important to capitalize on it in a big way. But the other variable to this equation that is probably even more important is to avoid investing in less-than-great ideas just to fill out a portfolio or meet some sort of arbitrary quota for diversification.

The benefits of focus investing are well known (and talked about ad nauseam), but there is a dichotomy between what investors say and what they do. Portfolio managers have a bias toward activity to justify their high fees. They also would much rather act conventionally (make frequent investments and own lots of stocks) than risk their jobs. The drumbeat of "what have you done for me lately" is very rarely muted in professional investing circles. Unfortunately, individual investors succumb to many of these pitfalls as well. This conventional wisdom is like a powerful magnet that eventually attracts most market participants. Social proof is a powerful force.

Everyone knows that to obtain results that are different from the crowd, you must behave differently than the crowd. But the reality when it comes to performance is that 90% of the people will make up the bottom 90%. I think it's imperative to recognize the reasons why this is the case, especially since we desire to be among the 10% of the people who are in the top 10%.

I really believe that, unlike in years past where investors' main advantage was finding hidden gems or uncovering information that others didn't have, the biggest advantage today is to leapfrog the short-term noise by maintaining a multi-year view and to patiently wait for great investments to present themselves.

2016 Portfolio Review

We made a very small number of investments in the past year, but the ones we made were relatively big swings. The performance in 2016 was mainly driven by three large positions, which surprisingly all happen to be large cap stocks: Apple, Berkshire Hathaway, and the banks (primarily J.P. Morgan and Bank of America).

I want to make clear that I have no preference for large caps over small caps, or vice-versa. My only preference is obtaining significant value for the price I pay for fractional ownership stakes in these businesses. I want to buy stocks when they are on sale, and it doesn't matter to me whether the market cap is \$100 million or \$500 billion.

We also invested in a few smaller stocks throughout the year, as well as a couple special situations—all of which combined for around five or six percentage points of performance. I expect that, going forward, the opportunities for finding value will likely be in more of the smaller stocks. But as I've said in [recent writings about where my "edge" lies](#), it's not in uncovering hidden gems, it's the patience and the long-term mindset that I'm able to adhere to, which contrasts greatly with the short-term focus of most other market participants who concern themselves with the outlook for the next few quarters.

We are agnostic on the size of the companies we invest in, but we are religious about taking advantage of volatility. This volatility is agnostic too—large caps are not immune to Mr. Market’s mood swings.

Here is a presentation I did back in October in Philadelphia that outlines my thinking on why large caps can get mispriced just as often as small-caps, and both should be considered as potential investment opportunities: [Three Paths to Finding Value Presentation](#)

Apple

Apple is a company I began looking at in the fall of 2015 when the stock dropped from around \$130 to \$90 in a matter of just a few months. This was a massive \$200 billion swing in market value, which I felt like was likely an overreaction one way or the other. As I began to think about Apple over the ensuing months, I came to realize one key variable that I think gave me a somewhat variant view from the majority of those who followed the company. As I visited stores, talked to consumers, studied their ecosystem, and considered the competition, I eventually came to the conclusion that Apple shouldn’t be analyzed as a computer hardware manufacturer, it should be thought of as a consumer brand.

Consumer brands like Nike, Coca-Cola, or Starbucks all do somewhat similar things: they buy commodities (their raw materials) and sell brands. Nike’s shoes and shirts might be nice, but the material isn’t all that different than Russell’s or Champion’s, but you may not have even heard of the latter two companies and you likely have paid a 100% markup or more for Nike gear. The commodity material is similar, but Nike gets its 50% gross margins thanks to the brand that it has built over time.

I think from a 30,000 foot view, the key variable in my investment thesis for Apple was that the company had a superior consumer brand (as evidenced by the fact it takes nearly all of the smartphone industry’s profits despite having less than a fifth of the market share). I felt this consumer brand was strong enough and durable enough to allow the business to continue to sell its hardware at very profitable levels.

Of course, the great business inside of Apple is their services business (the App Store, payments, music, etc...). The App Store did \$28 billion in revenue last year, of which Apple gets a 30% cut which is nearly pure profit. The services business alone will reach somewhere around \$30 billion this year, enough to place it inside the Fortune 100 if it were a standalone enterprise.

There are now over 1 billion Apple devices that are actively being used around the world, and this “installed base” continues to grow (over 100 million new active devices were added last year alone). Each of the billion devices act like miniature retail stores for Apple, collecting very high margin revenue on a recurring basis from the apps, games, music, storage, and payments.

While this services business depends on the hardware, I believe Apple’s brand will lead to very predictable sales—hundreds of millions of iPhones, iPads, and Macs are sold each year, and I am willing to bet that this will be the case 5 years from now as well. The argument against Apple has often been that it’s difficult to predict what product they’ll be selling, given the rapid change in the

technology landscape. I'd argue that whatever products become mainstream in the future, Apple will produce one that customers will buy. Two short years ago, Apple was not in the watch business. They are now the second largest watch company in the world.

When you look at Apple from a consumer standpoint, and observe the behavior of Apple's customers, it becomes clear that the company has something intangible that competitors like Samsung and others lack. Namely, I believe the company has a durable brand that will continue to lead to predictable sales over time.

When you combine this general view of the business with the incredibly cheap price the stock was trading at, it became apparent to me that there was significant value present in the shares. For less than \$95, you were getting a very high-quality business that was producing \$9 or \$10 of free cash flow per share, and you got \$30 per share of net cash to boot. At a P/FCF multiple of around 7 (after subtracting the excess cash), it seemed to be a no-brainer. Even at today's valuation of 10 or 11 times free cash flow, it still is very reasonably priced for such a good business.

I discuss this thesis more in this document: [Apple's Key Competitive Advantage](#)

We bought the stock in early January 2016, and added more in subsequent months, and it remains our largest position in the portfolio.

Berkshire and the Banks

I have talked about these two positions in previous letters, so I'll just link to some comments which contain the reasons I thought both investments were attractive, despite their large size:

- [Berkshire Hathaway](#) (March 2016 Comments)
- [Bank Basket](#) (July 2016 Comments; Updated January 2017)

Current Portfolio

I made four new investments over the past few months, including a few smaller stocks as well as a special situation investment. One of the four investments was Verisign, which is a great business.

Verisign operates the domain name registry for the .com and .net "top-level domains" (TLDs). This means the company acts as a directory for the internet, pointing people to the correct website when they type in any site ending in .com or .net. The company also provides essential services that are crucial to the functioning of the internet.

Verisign's position could be considered a "toll road" of the internet. They are the exclusive registry for .com and .net, giving them what could be likened to a monopoly. The company makes money mainly by collecting an annual fee (around \$8) for each of the 142 million .com and .net registered domains. If you have a website ending in .com or .net, Verisign is collecting its annual toll from you (via the registrar who sold you that domain name).

The margin on this recurring revenue is extraordinarily high, and there is very minimal need for cash in this business. The high margin recurring revenue and the low capital requirements lead to

stable and predictable free cash flow, which the company uses almost exclusively to buy back stock. In the last ten years, fully-diluted shares outstanding have shrunk from around 250 million to 125 million. The company simply collects its toll and consistently eats away at its own shares.

I wrote my thoughts on Verisign back in September, and a more detailed commentary on the business and the investment can be read here: [Verisign: The Toll Road of the Internet](#)

The other three investments, including one interesting special situation, will be discussed in some of the future letters as those investments unfold.

Final Note

Including dividends, I would expect the S&P 500 to produce somewhere in the ballpark of 7% to 9% average annual returns over time. You can match the performance of that index by investing in a low-cost S&P 500 index fund.

Therefore, just as the sole reason for the Buffalo Sabres' existence is to win a Stanley Cup, the sole reason for Saber Capital Management's existence (no relation to the hockey team) is to provide a superior alternative to that diversified, passive, low-cost index fund. Our goal at Saber Capital is to outperform the S&P 500 by 5% annually (net of fees) over rolling five year periods.

(Note: I have much more confidence in the long-term prospects for our investment vehicle than I do for my beloved hockey team, but I still hold out hope with the dawn of each new season thanks to those [comments that the new owner Terry Pegula made in that stirring press conference in 2011](#)).

You can expect intense focus from me on my investment process, and my hope and expectation is that the results will bear the fruit of this labor over the long-run. I appreciate that you believe this as well, as your investment with Saber is an implicit investment in me personally in many ways. It is an enormous responsibility and a real privilege for me to manage a portion of your capital, and I take this responsibility very seriously.

Thank you for your investment and your partnership with me and with Saber Capital.

Your Partner,



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Appendix and Disclosures

Here are a few letters and write-ups I've done that further discuss my investment approach as well as my thinking on some of our recent investments (some of these were linked to in this letter):

Investment Philosophy

- [Saber Capital Investor Note – Time to “Zoom Out”](#) (Election Comments 11/15/2016)
- [3 Paths to Finding Value](#) (10/25/2016)
- [What Is Your Edge?](#) (12/12/2016)

Recent Investments

- [Markel: A Compounding Machine](#) (4/4/2014)
- [Berkshire Hathaway is Safe and Cheap](#) (3/23/2016)
- [A True \\$1.00 for \\$0.70](#) (4/5/2016)
- [The Toll Road of the Internet](#) (9/2/2016)
- [Bank Stock Review](#) (1/18/2017)
- [Apple's Key Competitive Advantage](#) (1/31/2017)

I will also publish new content on Saber's website periodically, which will be updated here:

- [Saber Capital Management Commentary](#)

Disclosures

**Returns are based on the “Saber Capital Portfolio”—a real money account that is managed alongside all other accounts. I also refer to this as Saber's model portfolio. Performance data of this account is produced directly from Interactive Brokers. Returns are not audited. It is important to note that each client may experience slightly different results from the model depending on the timing of deposits, withdrawals, the opening/closing of the account, the fee structure specific to each account, other timing issues, etc... The valuations of your investments at the time of purchase may be significantly different than the valuations at the time of purchase in the model because of these timing issues. I expect the net results of the model account to roughly equal the results of client accounts over time, although there can be no guarantee because of the timing issues referenced above.*

The gross returns of the Saber Capital Portfolio are taken directly from Interactive Brokers. The net returns are estimated using a 1% management fee and 15% incentive fee. Your net returns could vary from the model depending on the fee structure of your account. Your personal account statements with your account specific performance net of all fees will be coming in the mail each quarter, and can also be accessed anytime online. Please note that any performance fees earned during this year will show up in the following year's 1st quarter's statement. Also note that the time weighted return (TWR) on your account specific performance summary is net of all fees.