Old West Investment Management, LLC

April 12, 2018

Dear Investor,

What a difference a quarter makes! In my year-end letter I bemoaned the fact that volatility had all but disappeared from the markets, and trillions had been invested in index funds with little regard to valuation. Much has changed in the first quarter of 2018, with market volatility returning with a vengeance and stock market indexes struggling to surpass January highs.

As you can see on your enclosed statement, we had a strong quarter in all of our portfolios. I believe the tide has turned, and you will see a shift in investor behavior with value stocks once again being in favor. It's interesting that each of the high flying "FANG" stocks all the sudden are having issues. Apple for the first time is facing negative growth in worldwide smartphone sales. Google is facing European and American government concerns over their near monopoly with digital advertising. Amazon has been in the crosshairs of President Trump, and Facebook's issues with customer privacy breaches will be a case study at Harvard Business School for years to come.

I have been sounding the alarm over market valuation for more than a year. I recently saw some new facts and figures that were eye opening. Over the past nine years the market has gained $25 T in value. That is five times greater than GDP growth, and twenty five times greater than the increase in profits. One of Warren Buffet's favorite measurements of market valuation is total market value as a percentage of GDP. That ratio known as "The Buffet Indicator" was 140% this past January. The only time it has been higher was in 2000 when it reached 150%.

I continue to be concerned with the health of the American consumer. The personal savings rate has fallen to a very low 3%, and subprime auto loans and credit cards delinquencies have been rising. In 2017 for every $1.00 in incremental household spending, 90 cents was borrowed. Basically the average American family is stretching to maintain their standard of living. Offsetting this is a very strong job market, and hopefully wage gains can help reduce borrowing.

Although we find the market indexes top heavy and overpriced, our portfolios are full of great companies selling for very reasonable prices. The Trump administration continues to make the business climate very friendly with its ongoing efforts to reduce needless regulations and lower taxes. Our team is very optimistic about the prospects of the owner/manager led companies that we own.

In my year-end letter I discussed three potential "black swan" events that could disrupt markets. The threat of a war breaking out with North Korea seems to be off the table. The other two, war breaking out in the Middle East and China's financial system imploding are still real possibilities. I have just finished reading a new book, China's Great Wall of Debt by Dinny McMahon, and I now believe the situation in China is even worse than I feared. I believe the Chinese Communist party recently gave President Xi Jinping a lifetime appointment because they know they are in dire straits, and the existing leadership is best equipped to deal with the coming crisis versus a new leadership team. The U.S. and many other countries are deeply in debt, but debt levels in China, both sovereign and private, are at such astronomic levels that a total collapse of their financial system is a possibility. When, I don't know, but the world's second largest economy is on very shaky ground.

The Trade of The Decade

Our team has been cognizant of the herd mentality and crazy valuations of the market indexes for all of 2017, and this past January. We also realized that the VIX index, which hit a record low of 8 in January, was incredibly low. The VIX index is a measurement of investor sentiment. The higher the VIX the more worried and cautious investors are. The lower the number the more complacent and comfortable. The VIX went as high as 80 in the last recession, and January's 8 was an all time low. The long time average of the VIX is 20. This is the background for my partner Brian Laks coming up with the "the trade of the decade." Brian writes the following:

> *Some of the biggest beneficiaries of declining volatility levels over the past two years had been exchange-traded products tied to the VIX, specifically those with an inverse return profile such as the XIV and SVXY. As volatility declined, profits from their short contracts and inflows from investors caused assets under management to balloon to several billion dollars by early 2018.*
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> *The daily rebalance mechanisms of these products created a positive feedback loop in which increases in assets required further short sales to maintain their required level of exposure. These actions, given their growing size and influence in the futures market, served to further depress the price, leading to further gains, attracting more inflows, etc. Investors in these products were either unaware or unconcerned that this dynamic could also operate in reverse.*
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> *With an inverse Exchange Traded Product (ETP), a 100% increase in the underlying index would lead to a 100% decrease in its value. As the VIX dropped lower and lower, the absolute amount it needed to rise in order to double naturally decreased as well. At one point it was estimated that as little as a 3% decline in the S&P would cause a corresponding rise in the VIX that could trigger a violent unwind of their positions and total loss of their assets.*
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> *In such an event, a simple short position would yield a 100% return. By using options, however, we could limit the capital at risk and greatly magnify the potential return. Because only SVXY had associated options, we chose that as the underlying instrument. Since the maximum value of a put*

option is the strike price, we compared each available strike price to its asking price to determine which contract offered the highest return.

The threshold was triggered on February 5 as markets fell precipitously and the VIX spiked higher. After the close, VIX-linked ETPs were forced to rebalance by purchasing huge amounts of futures contracts in a rising market where sellers had all but vanished. The losses they suffered were devastating. On February 6, after being halted until mid-morning, SVXY opened down over 80%. While not a total loss, the contracts we had purchased were well in the money and we sold them at a profit of roughly 13,000%, a 130-fold return on our investment.

It is extremely difficult and rare to find situations that offer such "hundred-bagger" return potential. While 'trade of the decade' might seem to comment on such an outsized return, it perhaps more accurately reflects the decade of distortion in financial markets that it took for the opportunity to appear.

Normally I highlight one or more of our holdings in these quarterly letters, but this quarter we are enclosing the recent issue of "Hidden Value Stocks," a publication written for industry professionals where Old West is a featured investment manager. We discuss three of our holdings in this month's issue; Zedge (ZDGE), Carbo Ceramics (CRR) and Enphase Energy (ENPH).

Thank you for your continued support and loyalty and we look forward to growing your hard earned money the balance of the year and beyond.

Sincerely,

Joseph Boskovich, Sr.
Chairman and Chief Investment Officer