Sweetbay Capital Management, LLC

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We are excited to announce the launch of Sweetbay Capital Management. Our philosophy is conservative and simple: we believe the surest path to wealth creation is by investing in high quality businesses, which have the ability to reinvest capital internally at high rates of return. In our view, this approach offers the greatest prospect for compounding investors' capital over long-term holding periods, and maximizing tax efficiency by minimizing portfolio turnover. Our strategy is to patiently accumulate shares of quality companies when those shares are offered at reasonable valuations. Our objective is to outperform the S&P 500 over the long-term.

When evaluating new investment opportunities, we look for certain defensible business attributes that insulate companies from competition. Examples include structural cost advantages, services that exponentially improve with increased customer usage, captive customers or high customer switching costs, dominant brands/franchises, and physical or digital assets that are difficult to replicate. Balance sheet strength and superior capital allocation are additional sources of value creation.

Loews Corporation (L) is an example of a company that uses its strong balance sheet to create value. Loews is a holding company run by the Tisch family. It owns majority positions in property & casualty insurer CNA Insurance (CNA), drilling rig company Diamond Offshore Drilling (DO), natural gas pipeline company Boardwalk Pipeline Partners (BWP), and a privately held chain of hotels. Loews has a long history of deploying capital opportunistically through share buybacks and business investments. The share count has been reduced from 1.3 billion in 1971 to 354 million currently. Opportunistic business investments include its original investments in CNA and Diamond Offshore. Loews invested in CNA in 1974 when it was bargain-priced due to the soft insurance market. Similarly, it began buying offshore drilling rigs in the late '80s when utilization rates were low, and thus rigs were available at a fraction of replacement cost. With these assets, Diamond Offshore Drilling was formed. The key to being able to take advantage of these opportunities is balance sheet strength. Not only is Diamond Offshore the best capitalized company in its peer group, but Loews holds $3.1 billion, or 18% of its net asset value, in net cash at the holding company level. Since CEO James Tisch took over from his father in 1998, Loews' book value per share has compounded at nearly twice the rate of the S&P 500 with dividends reinvested. Loews' stock trades at a material discount to net asset value, which we believe will grow over time.

Structural cost advantages are also a source of value and sustainability. Money is a commodity, but some banks pay less than others for the use of money. Banks that have high local market share often have lower cost deposits than competitors, as well as more deposits per branch, which results in superior branch-level economics. Once a depositor is in the door, banks can layer on more services over time, which has the double effect of improved economics and increased customer captivity. BB&T (BBT), as a result of having top five market share in nine different states, has a total cost of deposits lower than the commercial bank average, according to

the FDIC. Data from the FDIC also indicates that, compared to the commercial bank average, BB&T has a lower percentage of non-current loans, higher loan loss reserves relative to non-current loans, and higher equity capital relative to assets. Because of low interest rates and regulations that require banks to hold more equity capital than historically, bank valuations are low. BB&T trades at just 1.1 times book value, roughly half its historical multiple, despite a lower risk profile due to increased regulatory capital requirements.

Apple (AAPL) is a business that has created a powerful franchise and exhibits several defensible characteristics. Many customers have multiple Apple devices, and the platform is infused into their daily lives in various ways. Customers aren't going to subject themselves to the disruption and hassle of transferring and re-establishing the multitude of capabilities on a different platform unless the quality of Apple's software and hardware fall to an unacceptable level relative to the competition. Given Apple's enormous R&D budget and culture of innovation, we think that is very unlikely. The ecosystem Apple has created strengthens with increased per-customer utilization, which increases customer captivity. The latest version of Apple's iOS software is running on 83% of iDevices, compared to just 12% for its biggest competitor, Google's Android OS.[1] This seems to indicate a much higher level of customer engagement with the Apple platform. The ecosystem further strengthens as more new customers join, allowing Apple to increase its R&D budget and expand the market for app developers. App revenue on iOS is 70% greater than app revenue on Android.[2] Apple has essentially built a giant captive customer base that results in a valuable recurring revenue stream, yet the stock trades for just nine times consensus estimates for current fiscal year earnings, excluding net cash and investments.

We also seek assets with scarcity value. Well-located real estate is a good example, such as coastal real estate in Florida, a state where household formations are three times the national average. What's even better is if the value of that real estate is significantly understated on the owner's balance sheet. Because book value is a common measure of the worth of homebuilders, understated book value can translate to an undervalued stock price. That's exactly the scenario with WCI Communities (WCIC), which owns certain assets, including coastal condo tower development sites and the fourth largest real estate brokerage business in the state of Florida, the value of which we believe are significantly understated on the company's balance sheet.

Researching the sustainability of competitive advantages is just a part of our overall investment process, which begins with risk management. The following four tenets are key to our risk management strategy.

1) We avoid excessive financial leverage and other material on and off-balance sheet risks. We invest in companies with balance sheets that can easily weather full economic cycles.
2) We avoid businesses in secular decline, as well as companies that cannot earn returns above their cost of capital over an economic cycle. Time is the enemy of declining or weak businesses.

[1] Craig Federighi, Apple's SVP of Software Engineering, presentation at WWDC, June 2015.
[2] App store analytics firm App Annie, April 2015

3) We invest only in industries and companies that we understand. Perspective improves the more one understands a particular industry. Similarly, the likelihood of making a mistake increases without a thorough understanding of the market in which a company competes.
4) We avoid unreasonable valuations, as measured on an absolute basis and in the context of history. Valuation, while not more important than company fundamentals, should be part of the equation. Cash flows become less certain the farther out investors are forced to project. Exuberance can cause stock prices to reflect an assumption of future cash flows that are too distant and too uncertain than can be projected with any accuracy.

We believe our strategy is well suited for the current market environment. Businesses with sustainable competitive advantages have typically persevered through periods of economic uncertainty, and have ultimately prospered. We believe investing in high-quality, well-financed businesses at attractive valuations is the optimal pathway to build wealth over the long-term in a tax-efficient manner.

Please contact us with any comments or questions.

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Important Disclosures:

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