**BOYLE CAPITAL**

July 29, 2019

Dear Investor,

Portfolios have posted strong gains for the first half of the year and we believe are positioned for further gains in the second half of the year as housing finance reform proceeds and cheap value stocks play catch up to expensively priced growth stocks.

Our largest portfolio weighting, and most significant contributor to performance this year to date, is the preferred securities of Fannie Mae and Freddie Mac (we also own a small amount of common stock in Fannie Mae and/or Freddie Mac). Our views on the investments are well known and unchanged, though our conviction is greater than ever. The best path forward has always been to recapitalize the businesses as was done with major financial institutions like AIG in the aftermath of the great financial crisis. Doing so would not only represent the least amount of execution risk but would also maximize the taxpayer's investment. A memo signed by President Trump in late March started the move toward an ultimate recapitalization by directing Treasury and the Department of Housing and Urban Development (HUD) to put forward a comprehensive reform plan with the centerpiece of the plan being to end the conservatorships of Fannie Mae and Freddie Mac. The proposal was expected to be released in July (which is why we are later than usual with this update), however; recent comments by the Federal Housing Finance Agency (FHFA) Director Mark Calabria indicate the report which is "essentially done," is likely to be released in late August or September.

Until the proposal from Treasury and HUD is released, we expect share prices to remain volatile and sensitive to every so called "scoop," such as recent reports the administration is likely to wait until after the 2020 election to move on housing finance reform. A statement released by the White House on July 12th poured water on such reports noting that "housing remains a presidential priority and anything to suggest otherwise is false." In testimony to the ***Committee on Financial Services*** on May 22nd, Treasury Secretary Mnuchin stated "these were not entities that were intended to be under government control forever and funded by taxpayer money forever so I hope that Congress would look at this with us but if not we will do things administratively….this is a priority for us." An administration led re-IPO of Fannie and Freddie, similar to what was done at AIG, is eventually the path we expect the administration to pursue and most importantly **<u>does not require congressional approval</u>**.

As Director Calabria and Treasury Secretary Mnuchin have consistently stated in the past, the starting point of any reform plan is going to be capital. According to Secretary Mnuchin in an interview with *<u>Bloomberg</u>* on June 8th, "in any scenario we would want significant capital in front of a government guarantee. Could be an IPO, could be private capital, there are lots of ways of doing it but **<u>ultimately it would need a combination of retention and capital raise."</u>** The Treasury owns warrants entitling it to 79.9% of the common stock of both Fannie and Freddie, the potential value of which could be as much as $100 billion. In order to unlock this massive value though, Treasury must end the net worth sweep and begin the process of retaining and raising capital at the entities. We expect both these issues to be addressed in coming months through the Treasury/HUD plan and ultimately through a final agreement between Treasury and the FHFA. Once completed, it paves the way for Treasury and FHFA to begin the process of building capital through the public markets and that will ultimately require Treasury to address the junior preferred

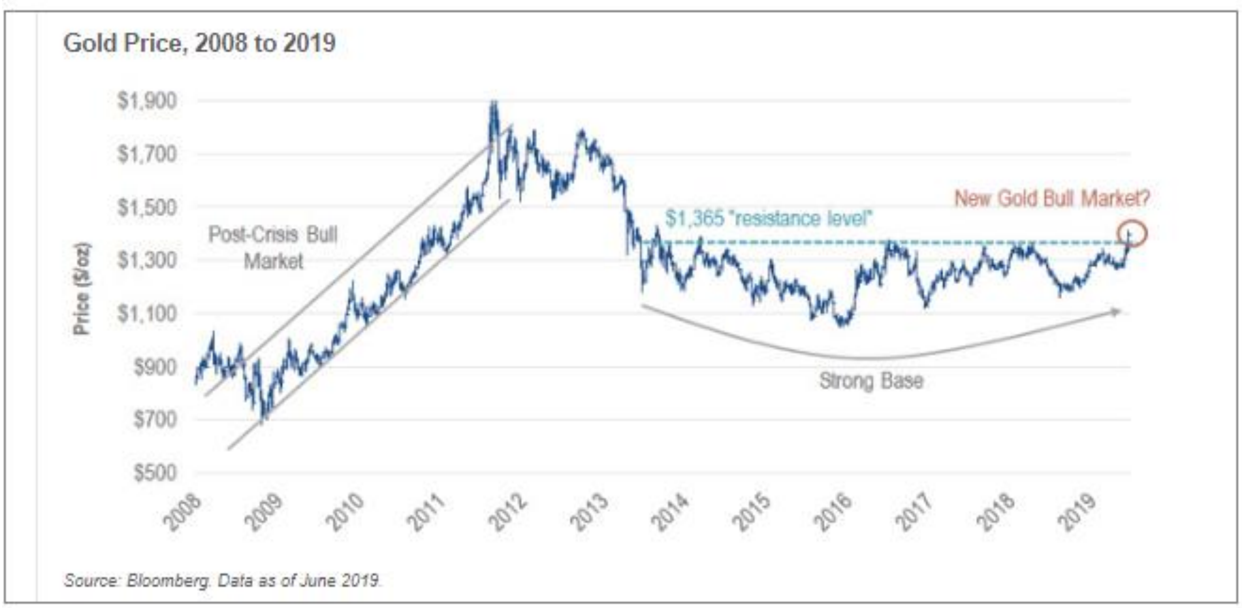
1230 Office Plaza Drive • West Des Moines, IA 50266 • **Phone** 515.327.1870 • **Toll-free** 877.327.1870 • **Fax** 515.619.5719 • www.boylecapital.com

securities (i.e. FNMAS). During a ***CNBC*** interview on May 21st, Director Calabria acknowledged the possibility of a preferred conversion when discussing the idea of a capital raise. In executing the recapitalization of AIG, Treasury converted the junior preferred stock into common stock near the equivalent of par value, which in the case of Fannie Mae (i.e. FNMAS) would be $25 per share. In the end we think it is likely that Treasury pursues a similar path with the recapitalization of Fannie and Freddie and given that shares trade for less than half that level today, we continue to find them attractively priced. Stay tuned for further updates….

Speaking of capital, the U.S. based megabanks such as Bank of America are swimming in it and have likely never been in better shape. Despite year to date gains on Bank of America of nearly 25%, shares remain attractive given the massive capital return program that is planned. Over the coming year, Bank of America is planning to return $37 billion to shareholders through a combination of dividends and share repurchases. At current prices, this works out to nearly 13% of the market cap being returned to investors in the next year. Since Bank of America began repurchasing its stock in 2015, the company has reduced shares outstanding by over 14% with half of that in the last year alone. This shareholder friendly return profile combined with increasing financial strength and scale advantages have resulted in the mega U.S. banks becoming more like utilities and likely a major reason Warren Buffett has nearly 50% of Berkshire Hathaway's stock portfolio in the mega U.S. banks (Berkshire is Bank of America's largest shareholder). Despite possessing similar economic characteristics to utilities in terms of dividend yield and return on equity, the banks trade at half the p/e ratio of the utility index (11 times forward earnings versus 21 times forward earnings). Rising rates and a steepening of the yield curve would be a huge lift for the banks to be sure, but it isn't necessary given the capital plans of the big banks. The valuation of Bank of America is undemanding and absent an economic collapse, shares should continue to compound higher over the next few years.

Our largest percentage gainer on the year, the warrants of AIG, are up nearly 200% from end of 2018 depressed levels. With an expiration in January of 2021, there is still enough time for the original thesis to play out (i.e. AIG common shares trading for at least book value per share of $69), however; time is not our friend with this investment so we will be dissecting AIG's second quarter report closely for continued evidence that the turnaround is on track. Given the potential time decay, our leash with the AIG warrants is likely to be very short over the next few quarters.

We sold our position in Amgen at a small gain during the quarter and used the funds to add to our position in Barrick Gold (GOLD) following the breakout of the price of gold (currently at $1,419) above the key resistance level of $1,365 (see chart below).



With more than $14 trillion of negative yielding debt around the globe (e.g. Switzerland's entire government bond market now trades with negative yields), the U.S. Federal Reserve is backed into a corner. If it continues the path of raising rates that it started in 2016, the result would be a higher dollar (U.S. rates would be attractive relative to negative yielding foreign government investments and thus the demand for U.S. treasuries would drive the dollar up). Eventually this higher dollar would cut into economic activity as U.S. exports would be more expensive. Consequently, the Federal Reserve appears to have very little choice but to become more accommodative. Historically, when the central banks have become more accommodative, it has not been a one quarter event. Over time, the price of gold has a strong negative correlation with the U.S. dollar. If dollar gains are likely to be capped by an accommodative Federal Reserve, gold and in turn the gold miners like Barrick, should be beneficiaries. It also serves as a hedge against geopolitical risks of which there are more than plenty out there today.

Last but not least is our exposure to the energy patch, namely in the form of Birchcliff Energy, which has remained an anchor on performance. Despite improving company fundamentals and rising oil prices over the last few years, there remains a significant disconnect between the underlying commodity price of oil and gas and stock prices (most oil and gas equities are at multi decade lows despite the recovery in oil prices). In fact, in relation to the overall market, energy has rarely been more unloved.

**Rejected**

The energy sector's weight in the S&P 500 index has hit a historic low, despite the recovery in oil prices over the past two years


Source: Bloomberg

American economist Herbert Stein penned "Stein's Law" during the 1970's when describing the record levels of inflation though he very well could have been talking about today's energy industry. In short, Stein's Law says, "if something cannot go on forever, it will stop." Loose capital markets allowed many energy companies to fund unprofitable growth and thus the result is the glut we see today. The cure for low prices in a commodity business has always been low prices and it is likely that 2019 will mark the year of change for energy. Take for example, the recent bid by Occidental Petroleum for Anadarko Petroleum. With the formerly loose capital markets all but closed to energy deals, Warren Buffett and Berkshire Hathaway were able to extract extremely attractive terms to help finance the deal, something that would have been unthinkable a year ago. Under the proposed terms, Berkshire Hathaway pledged to invest $10 billion into preferred shares of Occidental that come attached with warrants entitling Buffett to purchase up to 8 million shares of Occidental at $62.50 (OXY shares currently trade around $50 per share). The deal, if it goes through, allows Berkshire to put some of its $100 billion of cash hoard to work at attractive yields (the Occidental preferred would pay 8% annually). More importantly though, it is a vote of confidence from Buffett in the future of oil and gas and the value he perceives he is getting in return. After all, a large part of the value for any oil and gas company is the estimated recoverable reserves over time which in large part are a function of the underlying commodity price. In discussing the deal during the Berkshire Hathaway annual shareholder meeting, Buffett said the Occidental investment is a bet on oil prices rising over the long term and said Berkshire would have considered buying all of Anadarko had the opportunity been presented to them. Just as he harvested billions in profits from the investments he made in financials when nobody wanted them, it is likely Buffett and Berkshire shareholders will be greatly rewarded over time should the Occidental/Anadarko deal get approved.

In addition to Buffett, other "smart money" that has been taking advantage of currently depressed valuations are the insiders. Insiders at Birchcliff for example have made more than 30 separate purchases since the beginning of the year and not a single sale. At Tourmaline Oil, a Canadian oil and gas company we have used for selective Birchcliff tax swaps, CEO Mike Rose has purchased more than $68 million of his company's stock since last October. Like Buffett, the insiders know that value and price are not the same and the conditions that have resulted in the current historically depressed valuations are not sustainable. With capital markets closed for most energy companies, management teams are being forced to slow down growth spending and maximize cash flow to ensure their balance sheets are strong enough to weather the current storm. Diverting cash flow to debt reduction will eventually lead to lower production growth and signs are already starting to emerge that this is occurring in places like the Permian Basin, which has been the main driver of production growth in North America. In the meantime, global demand continues to gain ground in relation to constrained supply growth. Eventually the industry will rationalize and as it does, the capital markets will return. The longer it takes, the greater the recovery in underlying prices is likely to be.

Meanwhile, companies like Birchcliff, despite shares having reverted to end of 2018 levels, have rarely been safer. Free cash flow is on pace to be north of $100 million in 2019 and should reach a similar level in 2020 as well; equating to a free cash flow yield of more than 15% on current prices. Total debt of $650 million is likely to be chopped down substantially over the next 18 months as a result (nearly all Birchcliff's debt was used to build 100% company owned infrastructure that has led to operating costs among the lowest in Canada). As painful as this investment has been, now is not the time to throw in the towel. In a world where more than $14 trillion of capital is accepting a negative yield, long life resource companies trading for less than half of replacement value generating an attractive cash flow are not likely to last. A return to just 80% of liquidation value and four times cash flow would result in a near 100% increase in Birchcliff's share price from today's levels. We may not be at the exact bottom, but with investors like Buffett smelling blood in the water it is likely not too far off.

In closing, at a time when many consider the broad markets to be trading near full value, we believe our portfolios remain attractively priced and expect substantial gains as housing finance reform continues to unfold and historically cheap energy companies recover. Please do not hesitate to reach out if you have questions or if there have been changes in pertinent financial information or investment objectives.

Best Regards,

Brian F. Boyle

Brian F. Boyle, CFA

*The S&P 500 is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The index is used for comparative purposes because it approximates what an investor could earn from a passive investment in the general securities market.*