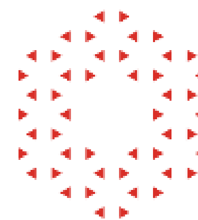
Moerus Worldwide Value Fund

Semi-Annual Shareholder Letter: Six Months Ended May 31, 2017



Dear Fellow Investors:

It is our pleasure to update you on recent developments regarding the Moerus Worldwide Value Fund (the "Fund"). This, our second Semi-Annual Shareholder Letter, will refer to the first half of the Fund's Fiscal Year, which covers the six months ended May 31, 2017.

In this Letter, we will touch on Fund performance, new investments made during the first half of the year, how and why such opportunities became available, and how our flexible, unconstrained investment approach has aided us in uncovering new ideas.

We were excited and honored to recently celebrate the Fund's one-year anniversary. We thank you very much for your support, interest and continued curiosity over the past year and hopefully in the years ahead. As always, we welcome any questions or queries that you might have.

Fund Performance (as of May 31, 2017)*

Fund/Index	6-Months	1-Year	Since Inception**
Moerus Worldwide Value Fund - Class N	15.86%	22.81%	22.81%
Moerus Worldwide Value Fund - Institutional Class	16.01%	23.09%	23.09%
MSCI AC World Index Net (USD) ***	13.37%	17.53%	17.53%

** Performance data quoted is historical, and is net of fees and expenses.*
***Inception date is May 31, 2016.*
**** The MSCI AC World Index Net (USD) captures large and mid cap representation across 23 Developed Market and 23 Emerging Market countries. With 2,501 constituents, the index covers approximately 85% of the global investable equity opportunity set.*

Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. Returns are shown net of fees and expenses and assume reinvestment of dividends and other income. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Please call 1 (844) MOERUS1 or visit www.moerusfunds.com for most recent month end performance.

Investment performance reflects expense limitations in effect. In the absence of such expense limitations, total return would be reduced. The Fund's adviser has contractually agreed to reduce its fees and/or absorb expenses of the Fund, until at least March 31, 2018, to ensure that total annual fund operating expenses after fee waiver and/or reimbursement (exclusive of any taxes, brokerage fees and commissions, borrowing costs, acquired fund fees and expenses, fees and expenses associated with investments in other collective investment vehicles or derivative instruments, or extraordinary expenses such as litigation) will not exceed 1.65% and 1.40% for Class N and Institutional Class Shares, respectively.

With regard to the table above, we'd like to reiterate something that we noted in our first Shareholder Letter, and will likely continue to emphasize in future letters: the Fund's performance data is noted simply for informational purposes for our fellow investors. The Fund invests with a long-term time horizon of roughly three-to-five years or more, and to be clear, it is not managed with any short-term performance objectives or benchmark considerations in mind. The investment objective of the Fund is long-term capital appreciation, and we manage the Fund with the goal of achieving attractive risk-adjusted performance over the long term.

Please keep in mind that while Fund performance has compared favorably to the benchmark to date, our investment approach can and will, at times, endure periods of relative under-performance. Short-term results will fluctuate, but again, our goal is to achieve attractive risk-adjusted performance and outperform relevant benchmarks over the long term, and we hope that our investors similarly take a long-term view.

Investment Activity in the Fund: Excess and Ensuing Crisis Bring Opportunity

During the first half of the Fund's Fiscal 2017 (six months ended May 31, 2017), we initiated three new positions in the Fund and added to many of our existing positions. These six months were active ones on the investment front, as we continued to find what we would characterize as unusually attractive opportunities to deploy the Fund's capital (more on this later). As a result, the Fund's cash position declined from roughly 21.3% at the end of November 2016 to around 12.9% by the end of May 2017. As of May 31, 2017, the Fund's portfolio included 37 holdings consisting of what we believe are attractive individual investments in companies across various industries and geographies, including North America, Europe, Asia, and Latin America. We will discuss the three new positions in the Fund shortly, but first, it might be helpful to briefly touch on a topic that is related to how these and other ideas come to the forefront of our investment efforts.

In our ongoing efforts to scour the globe in search of attractive investment opportunities to potentially add to the Fund's portfolio, one of the characteristics that we absolutely insist upon is a valuation that we view as unusually compelling. Passing only this *first* test (of many) is rarely, if ever, an easy task, particularly in today's capital markets, where dollops of easy money served up by the Federal Reserve over the better part of the past decade have inflated the prices of many different asset classes, including stocks, bonds and real estate. Not surprisingly, **assets and businesses, in general, do not become available at dirt cheap prices when skies are bright, the good times are rolling, and the current outlook is rosy.** On the contrary, such bargain pricing is often made possible only because the assets or businesses in question are either suffering from a poor near-term outlook, or are overlooked or neglected by the market because of their complexity or some sort of stigma that acts as a repellent to analysts and investors. Examples include:

- Companies operating in *industries* that are currently depressed (for example, the Energy sector at various points in recent years since crude oil prices began collapsing in mid-2014).

- Companies associated with *geographic markets* which have fallen into turmoil; take, for example, the United Kingdom immediately after the Brexit vote, or more recently Brazil after its latest high profile corruption scandal ensnared President Michel Temer.

- *Company-specific* events that result in a fall from grace in the market's eyes. Perhaps management has, for example, missed analysts' quarterly earnings estimates or slashed the company's dividend payments – events which never curry favor with short-term investors.

Whatever the specific case may be, **the cut-rate pricing that we require in order to invest in a business often brings near-term uncertainty, turmoil, or stigma along with it**. And while it may seem counterintuitive to day traders, momentum investors and other shorter-term players in the markets, we at Moerus actually embrace such negativity surrounding a potential investment. It is quite fine by us if our investments fail to win any popularity contests – after all, the assets wouldn't be on sale at such discounts if they were currently in fashion and in demand. In our view, having a very low "approval rating" on Wall Street – provided that it is temporary and does not call the fundamental survivability of the business into question – often contributes to the conditions for what ultimately become the most attractively priced long-term investment opportunities.

So in our experience, uncertainty, adversity and/or stigma have often accompanied some of our most attractive investment opportunities. Are there signals that sometimes point towards where such turmoil is present? As we noted earlier, pricing, for one, often provides us with a helpful guide to areas where there is *currently* turmoil or disruption, simply because if a company's stock price is unusually depressed, there is typically a "reason" for it, particularly amid an otherwise buoyant broader market. But taking this a step further, are there certain phenomena that sometimes help point us toward areas of potential opportunity in the *future*, allowing us to research, learn and conduct our due diligence ahead of time, in search of what might be the next interesting bargain?

In short, yes. While potential ideas come from many, various sources, throughout our history **areas of excess have frequently provided us with quite a bit of food for thought, often resulting in some of our most interesting investment opportunities.** For this reason, excesses often attract our attention, both as areas to avoid when they are in progress, and as potential sources of future opportunity in their aftermath, when we can assess the damage and sift through the rubble for possible gems.

All three new investments made in the Fund during the first half of its year – **Franklin Resources**, **NN Group NV** and **UniCredit SpA** – were opportunities borne out of a backdrop that has been influenced by what we see as areas of considerable excess, most notably:

- The avalanche of investor assets *into* passive investment vehicles (including index funds and ETFs) and *out of* actively managed funds (for example, hedge funds or mutual funds).

- The phenomenon of low, zero, and even negative interest rates, as implemented primarily by the Fed in the U.S., the ECB in Europe and the Bank of Japan.

Let's get a bit more into these excesses that we are currently seeing in the investment world, and how they have allowed us to take advantage of what we believe are exciting longer-term opportunities for the Fund.

The Death of Active Management?

Hyperbole and eye-catching headlines in the financial press tend to get our attention because they occasionally provide a window into areas where excesses may be building, sowing the

seeds for potential opportunities in the future. Some headlines from time to time point us to areas where bubbles may be forming – for example, the proverbial "*This Time is Different*" argument that has surfaced in some form near the peak of many past investor manias. At the opposite end of the spectrum, excessively negative headlines often lambaste the losers of the day in Wall Street's never-ending popularity contest. To that latter point, one of the most frequent targets of extremely dire coverage in the financial press in recent years has been the field of active investment management.

As you probably know, active management, or the practice of picking specific stocks, bonds, and other assets with the goal of outperforming a general market index, has been under siege of late. In 2016 in the United States alone, passively managed funds – whose investments are not chosen by a portfolio manager but instead are systematically selected to match an index or specified part of the market – attracted almost $505 billion of assets. The *inflows* to passive products came mostly at the expense of actively managed funds, which suffered $340 billion in *outflows* during 2016[1]. In a nutshell, the problem for active management centers on many actively managed funds having failed to outperform benchmark indexes in recent years. This has prompted a shift of investor assets into passive funds that are designed, at a lower cost, to virtually match their respective indexes.

Headlines such as "*Is Active Management Dead?*" and "*Who Killed the Active Fund Manager?*" – yes, those were actual titles – typify the extent of the extremely negative sentiment towards active management in recent years. The gloom and pessimism surrounding the field, in addition to the headlong stampede into passive investing that has taken place in recent years, have provided us with an interesting opportunity to invest in **Franklin Resources**, a high-quality company operating in what we believe is still a very, very good business, recent challenges notwithstanding. But before we dig deeper into Franklin Resources, let's discuss active management in general.

Given our decision to launch Moerus Capital in late 2015 and then this Fund in mid-2016, it perhaps goes without saying that we strongly believe in the merits of active investing. There have been many thoughtful, well-articulated comments made and pieces written by some of the most successful, well-known investors in defense of active investing and on the limitations of passive investing. While we don't want to reinvent the wheel by making our own case here, there are a few points that we'd like to make.

First, although it is true that many active funds have struggled to beat their benchmarks in recent years, history is replete with the cases of active managers who have compiled track records of impressive, market-beating risk-adjusted returns over the long-term. For those who maintain a long-term focus, choose their funds and managers wisely, and don't trade in and out of the market frequently, we believe there is a real opportunity to generate risk-adjusted returns that beat the market. **Remember that passive investing inherently *guarantees* mediocrity – returns slightly below those of the relevant index being tracked (after fees).** We believe that investors can do better than that if they have a long-term approach, stick with

[1] "Who Killed the Active Fund Manager?," by Mark Gilbert, *Bloomberg:* https://www.bloomberg.com/gadfly/articles/2017-04-04/index-king-vanguard-knows-who-s-killing-active-managers

it, and invest with high-quality managers who have demonstrated expertise in their respective métier.

On a related note, in offering their opinions on the active versus passive debate, many in the financial media have focused their attention mostly on *returns*, noting that many active funds have failed to beat market indices in recent years. Unfortunately, far less often have we seen an adequate discussion of *risk*, specifically the risks assumed by blindly investing in every company in an index – this is what investors in passive funds are essentially doing – regardless of valuations and margins of safety (or lack thereof). In our view, "passive" investing is a bit of a misnomer, in that anybody who invests in an S&P 500 index fund, for example, is actively making a decision to invest in every company in the S&P 500, and assuming whatever risks that entails. While it is true that investing in such a fund assures an investor that he or she will not *materially underperform* the S&P 500, it also ensures that the investor will be *fully exposed* to any significant declines in the index. This may be tempting for the average investor to overlook after over eight years of a generally rising stock market (as we have seen in the U.S., at least). But here are some historical facts that may give pause:

- If you were invested in the S&P 500 at its September 1929 peak, before the stock market crash and the Great Depression that followed, you would not have seen the index return to those levels again until the middle of 1954, nearly 25 years later.

- Investors in the NASDAQ index in March 2000, at the peak of the tech bubble before it burst, did not see the index return to those levels until mid-2015, some 15 years later.

- Japan's TOPIX index still, to this day, hasn't even come close to revisiting its peak reached in December 1989, when the Japanese market was the darling of the investment world.

  Source: Bloomberg

To be clear, active funds obviously would not and will not be immune to any significant declines in the broader market. However, investors in passive products will be fully exposed to any such market declines. **Well managed active funds, on the other hand, offer at least the possibility of mitigating downside risk somewhat by various means, including for example, by avoiding the frothiest segments of the market, steering clear of fundamentally higher-risk investments such as highly indebted companies, and holding some cash in the absence of attractive opportunities.** This potential for risk mitigation, we think, may be underappreciated by investors in the current market environment, which for example, has seen the S&P 500 return nearly 300% (including dividends) since its March 2009 low. We suspect that at some point, this attribute of active management might yet regain appreciation as investors are once again reminded that after all, trees really do not grow to the sky – and perhaps neither do the stock prices of the Facebooks and Amazons of the world.

A few other points on the subject. One of the arguments for passive investing is that the market is efficient, making it difficult for active managers to beat the index after fees. But as a passive fund becomes increasingly popular, its inflows are used to purchase securities in proportion to their respective weights in the index that the fund tracks. Larger market cap companies are typically weighted more heavily in indexes than smaller companies. Therefore, increasing flows into passive funds, in general, will systematically, blindly favor larger, more liquid companies,

regardless of valuation and other fundamental concerns. **As passive funds continue to take share from active funds, we believe that, somewhat ironically, they will make the market more inefficient, helping high-quality active managers outperform over the long term.** Furthermore, between 2007 and 2016, as passive funds continued to gain in popularity, almost half of all actively managed U.S. equity funds disappeared[2]. As outflows have thinned the herd of active funds that search the markets for bargains, market inefficiencies may increase and the opportunities to outperform via stock picking may improve as a result of reduced competition (fewer eyes looking for deals).

Finally, the past decade has seen an unprecedented era of loose U.S. monetary policy, easy money, and ultra-low interest rates. It is our belief that with capital so easy to come by and with all of that excess liquidity flowing around looking for a home, valuations and fundamentals of specific stocks began to matter less to investors and correlations between stocks increased, creating a difficult environment for active managers to differentiate themselves enough to beat the index in the short term. We believe that this is a somewhat *cyclical* phenomenon, and that if the Fed eventually begins to tighten in earnest, capital will become "pickier," enabling good long-term active managers to outperform as valuation and the fundamentals of individual businesses regain importance. In fact, correlations between stocks have already begun to decline meaningfully in recent months.

To be clear, there is certainly a *secular* element in the shift towards passive funds given their lower fee structure and regulations that have nudged the shift along. However, we believe that there is also a *cyclical* aspect to active funds' performance relative to the broader market. In our view, if the cycle turns and an increased number of actively managed funds begin to outperform the broader market, we believe that this will slow the tide of net outflows from actively managed funds. **In short, we believe that rumors of the death of active managers are exaggerated, at least with respect to those managers who offer a compelling product that generates attractive, risk-adjusted returns, after fees, over the long term.** Furthermore, the ongoing shakeout of the weaker, less compelling players in the industry may very well prove healthy and beneficial for the survivors in the long run.

Franklin Resources, Inc.

Our belief in its merits notwithstanding, the pall currently cast over active management by the market has resulted in some interesting opportunities to invest in high-quality asset managers at attractive prices. During the first half of the Fund's Fiscal 2017, we initiated a position in shares of Franklin Resources ("Franklin"), a U.S.-based, global asset manager with a current market cap of roughly $25 billion. Franklin currently manages around $740 billion in assets across several fairly well-known brands, including Franklin, Templeton, Mutual Series, and Fiduciary Trust.

Over the last few years, like most of its competitors, Franklin has been stung by the industry-wide shift towards passive management. But even in these very challenging times and despite experiencing significant outflows, we believe that Franklin's business remains very attractive.

[2] "Who Killed the Active Fund Manager?," by Mark Gilbert, *Bloomberg, 4/4/2017:* https://www.bloomberg.com/gadfly/articles/2017-04-04/index-king-vanguard-knows-who-s-killing-active-managers

As evidence of this, in its Fiscal 2016 the company managed to register a healthy 36% operating margin and generated net earnings and free cash flow of $1.7 billion and $1.6 billion, respectively. The shift to passive strategies has been more pronounced for Franklin than for competitors in recent years because Franklin's large global bond and income funds experienced poor relative performance in 2015 and in the first part of 2016. However, these funds have rebounded strongly over the past year, and continue to boast impressive long-term track records. In fact, based on Assets Under Management (AUM), 71% of Franklin's mutual funds are in their top-two peer group quartiles over the past five years and 81% are in the top-two quartiles over the past ten years. Such solid long-term investment performance should position Franklin well as more poorly performing active managers get called to account in the aforementioned shakeout.

Franklin's rock-solid balance sheet, including net cash and investments of about $10 billion (as of March 31, 2017), or roughly 40% of its current market cap, provides the company with a significant cushion to protect against adversity and offers management the flexibility to pursue interesting strategic options. The current turmoil in the industry has enabled us to invest in a prolific cash flow generator like Franklin at what we believe is an attractive valuation; stripping out the company's cash, the business currently trades at around 9 times earnings, 6 times EBITDA, and only 2% of AUM.

Of particular interest to us is our view that the current valuation appears to ascribe only minimal value to the company's huge portfolio of cash and investments. There are several ways that Franklin can potentially unlock this value. The company could, for example, make acquisitions of smaller asset managers, which may generate a higher return than what it's currently earning on its cash. Alternatively, if Franklin is willing to repatriate some of its cash held overseas, we estimate that the company could either conduct a large share repurchase of up to around 22-23% of outstanding shares, or pay a special dividend of around $10 per share. Note that we don't view these as "blue sky" type estimates; in fact, we estimate that Franklin could potentially do either while still maintaining a net cash balance sheet and without using more than $3 billion of its seed investments in its sponsored investment products.

A very strong balance sheet is not always a panacea, particularly for companies which choose to rest on their laurels rather than continue a constant drive toward shareholder value creation. But Franklin's financial flexibility is particularly interesting given its impressive track record of both using its strong free cash flow to return cash to shareholders – including about $9 billion used to repurchase around 25% of outstanding shares over the past 10 years and another $5 billion in dividends – in addition to making sound acquisitions over the years, including Templeton, Mutual Series and Fiduciary Trust. In short, we believe that this company is cheap on an as-is basis, but it also offers the potential to either return cash to shareholders through dividends, repurchase shares at reduced prices and materially diminish its shares outstanding, or spur future growth by acquiring other asset managers that are suffering from industry headwinds. Either of the latter two routes offers meaningful potential to enhance *per-share* value for shareholders over the long-term, particularly in the event that conditions for quality active managers improve.

Low/Negative Interest Rates and Squeezed Life Insurers

Another of the more obvious areas of excess that we have been watching for some time now has been the phenomenon of low-to-zero-to-negative interest rates and "Quantitative Easing," as implemented by monetary policymakers in the U.S., Europe, Japan, and elsewhere over an extended period. Central bankers and their advocates argue that low interest rates have been necessary to grease the wheels of the global economy that ground to a halt in the Global Financial Crisis nearly a decade ago. While drastic measures were probably necessary and helpful in enabling the financial system to continue to function during those particularly traumatic months in 2008 and 2009, the net benefits, if any, of such loose monetary policy seem much less clear today, some eight-plus years on.

In any event, we believe that abnormally low and even negative nominal interest rates are a strange pathology of our times that, if they continue to persist, could potentially result in serious unintended consequences that might prove to be very difficult, if not impossible, to comprehend without the benefit of hindsight. Many have benefited from low and negative interest rates, including borrowers such as sovereign governments, corporations and consumers, as well as the owners of many financial assets (stocks and bonds) and real estate. Other groups, however, have been hurt by low interest rates. Savers, for example, who rely on interest income have been hurt for obvious reasons. Those who do not own property or a great deal of financial assets have been squeezed as well, particularly as rents have increased and affordability in various housing markets has deteriorated. Banks have been one of the most often mentioned "victims" of low and negative interest rates, as their net interest margins, and resulting profits, have been squeezed as a result.

Life insurance companies make up yet another group that has suffered in recent years due, in part, to low interest rates. When the European Central Bank slashed its base rate to zero in March 2016, Oliver Bäte, the head of Allianz (Europe's largest insurer) called it "a catastrophe[3]." Why? Consider life insurance policies that were written back in the 1980s and 1990s, some of which guaranteed policyholders minimum annual returns of 3%, 4% or more. Older-vintage assets that life insurance companies have been holding on their balance sheets for decades, which have been paying much higher interest rates than what is currently prevailing in the market, eventually mature and begin to roll off of insurers' investment portfolios. As a result, life insurers are increasingly left trying to figure out how to reinvest these proceeds into new bonds available in the current market, in which low and even negative interest rates prevail, and yet still meet the guaranteed return requirements that they committed to years ago. Therein lies the problem – or at least one of the main problems. In addition to low interest rates, other issues currently plaguing the European life insurance industry in general include increasingly restrictive regulatory and capital requirements, the need for dilutive capital raises, weak investment performance and subpar underwriting.

As a result of these challenges, the common stocks of many life insurance companies have traded down to increasingly interesting levels in recent years, with some trading well below book value. Naturally, this turbulence caught our eye and we took a closer look. After looking at one of its competitors that we ultimately passed on due to what we viewed as thin capital ratios,

[3] "Insurers Hit By Zero Interest Rates," *Handelsblatt Global*, 3/14/2016: https://global.handelsblatt.com/finance/insurers-hit-by-zero-interest-rates-469580

somewhat dubious corporate governance and its relatively risky investment portfolio, we learned about **NN Group NV** and eventually initiated a position in the Fund during the first half of Fiscal 2017.

NN Group NV

NN Group is a leading Dutch life insurer with strong businesses in European insurance, asset management and in Japanese Insurance. The company, whose history dates back to 1845, was previously a subsidiary of ING Group. We were initially attracted to the company's robust capital levels, including a Solvency II capital ratio of 238% (as of March 31, 2017). This is more than double the 100% regulatory requirement, which represents the capital needed to absorb an estimated 1-in-200 year loss. This robust capital position – again, in an otherwise troubled field – recently enabled NN Group to opportunistically acquire Delta Lloyd, a Dutch competitor whose thinly capitalized balance sheet forced it to consider strategic alternatives. NN Group was able to purchase Delta Lloyd at a nearly 60% discount to where the stock traded two years ago and a 35% discount to book value. We believe this transaction offers significant strategic benefits and synergies, and seems likely to be quite accretive to earnings.

Even with NN Group's strong financial position and recent opportunistic acquisition of Delta Lloyd, we believe the stock's valuation is unusually attractive, at only 47% of reported book value, 8 times earnings, and a 20% discount to our conservative Net Asset Value estimate, which uses the company's reported Solvency II disclosure to mark its liabilities to market. We believe that at such a depressed valuation, NN Group represents a very interesting long-term opportunity for the Fund, with additional upside potential if interest rates eventually reverse course and increase.

UniCredit SpA and the Italian Banking Sector

UniCredit SpA is a leading pan-European bank that is based in Italy, where it is the second largest bank operating in the country. The intriguing opportunity that we believe UniCredit currently represents is ultimately the result of not one, but a *number of excesses* on various levels. Yes, one of the factors contributing to the entire Italian banking sector's current predicament is the same ultra-low interest rate environment that has laid low the life insurance industry. Low rates have pressured the net interest margins earned by Italian banks, exacerbating the already low/negative returns on equity that many of them had been earning. However, a more important issue for Italian banks has been the fallout from the European Sovereign Crisis (and its periodic flare-ups), and lack of adequate balance sheet quality across many companies in the space.

The excessive spending of many peripheral European governments, which had been essentially living beyond their means for years, in addition to a bevy of embedded inefficiencies within their economies that had been somewhat masked by the governments' largesse, eventually led to the Sovereign Debt Crisis which, in turn, resulted in various austerity measures that have stifled many of these economies for the past several years. The Italian economy has been among the hardest hit, enduring a double-dip recession and roughly a decade-plus of stagnation. These macro headwinds exacerbated what had been generally very poor loan underwriting over the

years by many Italian banks, resulting in the massive non-performing loan (NPL) issue that currently afflicts much of the industry. One final area of excess to note is within the structure of the Italian banking industry itself – Italy is far too fragmented and over-banked, both in terms of number of rival banks as well as in number of bank branches, which despite some recent consolidation still outnumber pizzerias in Italy[4]! Not surprisingly, this industry fragmentation has further depressed profitability.

In our historical experience, many of our most interesting long-term investment opportunities have sprung up amid seemingly abysmal backdrops, and we believe the challenges facing Italian banks offer similar potential. UniCredit, like many other Italian banks, had been plagued by NPLs and inadequate capital levels for many years. To give you an idea of the magnitude of the carnage, consider that between 2007 and 2016, UniCredit common stock declined by more than 90%. However, the company has recently begun to address their issues by bringing in new management led by CEO Jean Pierre Mustier, who spent most of his career at Societe Generale. Management has moved swiftly, taking an €8 billion loan loss provision in the Fourth Quarter of 2016 to boost its loan loss reserve coverage, in addition to completing a €13 billion rights offering to significantly strengthen its financial position. Also, while other Italian banks seem unable or possibly a bit unwilling to sell off portions of their NPLs – perhaps because potential buyers are offering significantly less than the values at which they are marked on banks' balance sheets – UniCredit has sold off chunks of its NPLs at market-clearing prices, further cleaning up its balance sheet. These recent events position the company to potentially be a prime beneficiary from further consolidation in the Italian banking industry, as many of UniCredit's weaker competitors have been unable to raise outside capital and are in varying stages of wind down. Given its strengthened balance sheet UniCredit, indeed, may prove to be one of the players which drive consolidation going forward. Longer-term, we believe that such consolidation, in addition to a much healthier capital position, could improve the economics of UniCredit's business materially, and the company possesses significant tax assets that could potentially be deployed to enhance after-tax profits. Despite these positive developments, the Fund was able to establish its position at a discount of about 35% to a sharply written down and more credible book value, as crisis once again brought us opportunity.

The Benefits of Unconstrained Investing: "Stuff to Do"

Having founded Moerus in late 2015 and launched the Fund in mid-2016, we occasionally stop, take a step back and look back at the journey so far. As we look back and assess what we have done on the investment side thus far, one of the things that has been somewhat noteworthy to us is quite simply that, in plain English, there has been stuff to do! This perhaps might not seem like much of a revelation since, after all, it is our job to search for and find investment opportunities that we believe are attractive – it is what we strive to do each and every day. However, a familiar refrain that we have read and heard recently from quite a few fellow investors, particularly tried-and-true value investors, was just how challenging it has been of late to find attractively valued investment opportunities in the current market environment. Many of these investors are friends of ours who have been wildly successful, have compiled

[4] "The complicated failure of two Italian lenders," *The Economist*, 7/1/2017: https://www.economist.com/news/finance-and-economics/21724401-splashing-taxpayers-money-not-pretty-it-pragmatic-complicated

enviable long-term investment track records, and whom we hold in the highest regard. For many of them, cash levels have been building as a result of what they view as an absence of compelling investment opportunities.

Again, we found this observation interesting because as we have gradually built out the Fund's portfolio since it was launched over a year ago, our cash levels have trickled down over time (to 12.9% as of May 31, 2017) as we have found what we believe to be exciting long-term investment opportunities. In assessing why we've been able to deploy capital while other notable value investors have held back somewhat, what's intriguing is that we largely don't disagree with their argument that valuations, *in general*, are challenging in numerous pockets of the investible universe. With the S&P 500 Index currently trading at a Cyclically Adjusted Price-Earnings Ratio that has only been surpassed in 1929 and in the late 1990s during the dot-com bubble, the U.S. market, in general and at a high level, is not attractively valued, particularly for cheapskates like ourselves. Similarly, we view India as a very attractive part of the world to invest in terms of having many interesting and promising businesses and it has, in fact, periodically offered us tremendous opportunities in the past; however, valuations there have also been utterly uncooperative of late. While certain pockets of the universe currently excite us (such as some European financials as previously discussed), we are sympathetic to the view that *markets* in general aren't dirt cheap.

So if, very broadly speaking, we agree that numerous pockets of the global markets are not cheap enough, why have we been fairly satisfied with extent of the investment opportunity set while many other value investors have had trouble finding truly attractive stuff to do? **We attribute this phenomenon to the benefits of the style and philosophy of unconstrained investing that we practice at Moerus. We are willing and able to go anywhere we see compelling risk-adjusted value.** This approach provides us with what we believe is a meaningful advantage over other managers whose activities are limited by any number of factors (by choice or otherwise), including the following:

Size. Many of the other firms that we allude to have proven to be very skilled, successful investors over the years. With success comes size, as individual and institutional investors naturally want to get on board with successful managers, ultimately increasing such managers' Assets Under Management (AUM). Unfortunately, the drawback of increasing size for managers is that it eventually pushes up the size of the individual investment opportunities that they could potentially select. To wit, for an investment strategy with $10 billion in AUM to build a 2.5% position in a new idea – the level at which we think an investment would represent a reasonably meaningful position in a given portfolio – it would require a $250 million investment in that single security. Such an investment would result in the strategy needing to own 25% of any company with a market cap of $1 billion, 12.5% of a $2 billion market cap company, 5% of a $5 billion market cap company, and so on. For larger strategies with AUM of $20 billion, $30 billion or more, the extent of the problem is magnified as size increasingly forges an anchor. Why could this be a problem?

Generally speaking, owning such large percentages of a given company could be problematic and disadvantageous for an investment strategy because it is not always easy to buy and sell shares without adversely influencing the share price of the stock that it is trying to buy or sell. When a manager is buying such a large percentage of a company's stock, he or she is likely to drive the price up because the strategy's "demand" for the stock is such a large chunk of the

stock's overall "supply." The opposite effect is likely when trying to sell such a holding, driving down the stock price and the ultimate proceeds that a strategy's portfolios will generate for its investors. Other factors can also make owning such a large percentage of a company problematic, including regulatory restrictions and requirements that vary by market. As a result, many managers of very large strategies eschew investments in smaller and mid-sized companies; in effect, their available opportunity set is much smaller because of size-related restrictions. This can prove especially challenging for large value managers in times like the present, where the stampede of cash flowing into index funds and other passive products has, as noted earlier, disproportionately flowed into larger cap companies, pushing up their valuations.

At Moerus, we have the advantage of being free from such size-related constraints, and as a result we can look into nooks and crannies of the market that others simply can't. Of course, Moerus and the Fund are still in their early days and you're probably not surprised that size is not a current constraint. But even longer term, we do not intend to grow to an AUM level that would restrict the universe of potential investment opportunities that is available to us. Perhaps we may be accused of having relatively modest ambitions in a business sense, but so be it. We believe that our unconstrained approach provides us with a key advantage in our efforts to achieve our goal of attractive risk-adjusted returns over the long-term for ourselves and our fellow investors. For that reason, we are very mindful of avoiding the restrictions that come with size.

Geography. Some areas of the world that are perceived to be challenging places to invest by many investors have historically offered us some of our best opportunities over the years. **Having the mindset and ability to look in places that other investors avoid quite literally opens up a world of opportunities that are much less picked over than some of the conventional, more "crowded rooms."** This may result in our Fund having a geographic breakdown of assets that may, at times, seem unusual to conventional investors, but it will also reflect wherever we are seeing what we believe are the best opportunities at that point in time. For example, as of May 31, 2017, 9.1% of the Fund's assets is invested in Colombia. This may strike many investors as odd, but it isn't to us – we have been investing in Colombia since the early 2000s, and some of our most successful past investments have originated from there. We are highly confident that the investment that the Fund made in **Almacenes Exito S.A.**, the largest retailer in all of South America (which we highlighted in our prior Shareholder Letter), would not have been priced nearly as cheaply if the company happened to be based in the U.S., Europe, or even in Mexico – instead of Colombia. Neither would our investment in **Organizacion Terpel S.A.**, the dominant fuel distributor with over 40% market share in Colombia – a market that offers exciting demographics and secular drivers of potential long-term growth, including a young, growing population, very low penetration of car ownership relative to its closest neighbors, and a massive infrastructure plan in progress to expand and upgrade the country's road network. Our willingness and experience in combing through markets that other investors tend to avoid further expands our universe and the potential to uncover bargains others don't see.

The Pursuit of "Quality." As we look at the investing world, one of the things that we've noticed over the past several years has been that one of the big drivers of investment opportunities, perhaps increasingly so, for many investors, has been the pursuit of quality.

What is quality? Obviously it means different things to different people, but as broadly recognized by many investors, quality often tends to include businesses that consistently generate strong income statement-based statistics or other metrics – high Returns on Capital, for example – and/or strong competitive positions ("moats" as made popular by Warren Buffett), franchise value, quality brands, etc. Investing in so-defined high-quality companies has served many investors quite well in recent years. However, this success also means that such stocks, in general, have, to our eye, gotten much more expensive in recent years. Hence for many value investors who adhere to their chosen discipline on valuation, opportunities to invest in high-quality companies at bargain prices may very well be coming fewer and farther between in recent years.

Our approach to investing, on the other hand, requires what we see as unusually low-priced investments. Cheapness (in terms of an attractive valuation) is one of our most important investment criteria, alongside what we view as adequate safety of capital. By unlinking ourselves from a requirement to invest in high quality companies (as previously, broadly defined), we are able to benefit from a larger universe of potential investments than other investors with such a restriction. **To be clear, we do not have anything against moats, brand names, or other attributes of high quality companies. In fact, we love opportunities to invest in them. We just don't like paying up for them.** Further, we believe that not restricting ourselves to companies perceived as high quality *today* enables the Fund to potentially benefit from some high quality companies of *tomorrow* – situations in which the economics of a business' recent past and present could improve materially in time, given changes in industry structure, corporate/asset structure, management, *et al.* And tomorrow's high quality companies, if shunned and if the potential for improving circumstances are not fully appreciated by Wall Street, are often priced more cheaply than today's high quality companies. We believe that by not limiting our investments to what is currently broadly perceived as quality, we enable the portfolio to potentially benefit from such transformations.

In summary, while the market in general has not been very cooperative, we have nevertheless found ample opportunities to deploy the Fund's capital into what we believe are attractively valued investments. **Moerus' unconstrained approach to value investing means that there is always something, somewhere to learn about, study, investigate and often invest in, provided the price is right.** We look forward to the continued pursuit of potentially lucrative investment opportunities, whenever and wherever they may appear.

As always, many thanks again for your continued support, interest, and curiosity. We look forward to writing you again later after the close of the Fund's Fiscal Year.

Sincerely,

Amit Wadhwaney

Portfolio Manager

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