

# MARRAM INVESTMENT MANAGEMENT LLC

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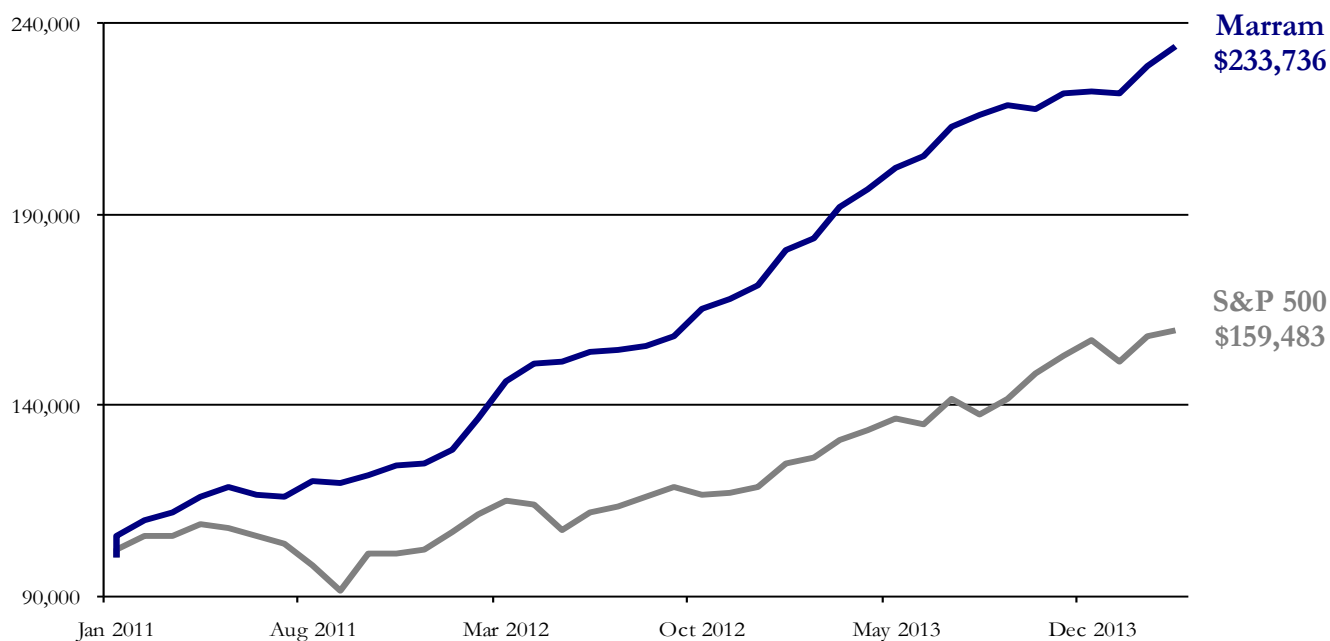
Dear Investors,

The Portfolio\* appreciated +5.13% in the first quarter of 2014.

During this same period, the S&P 500 returned +1.81%.

For monthly details, please see Historical Performance Returns at the end of this letter.

## **\$100,000 Investment in Marram\* vs. S&P 500 (since Inception)**



## INVESTOR COMMUNICATION REMINDER

To better emphasize the importance of a long-term approach to investing, we have discontinued our monthly return updates via email. You can still access your monthly account returns anytime online via Interactive Brokers' Account Management platform (let us know if you need a refresher on how to do so).

We also modified the format of our quarterly letters to include the following sections:

- *Marram's Five Pillars* – constant reminder of “why” and “how” we invest capital
- *Portfolio Allocations* – breakdown of our current capital allocation
- *Portfolio Return Analysis* – analysis of performance returns
- *Portfolio Future Positioning* – glimpse into our current thoughts on markets, asset prices, and/or how we are positioning the portfolio to maximize future compounding

## MARRAM'S FIVE PILLARS

INVESTMENT GOAL:	<ul style="list-style-type: none"><li>• To Compound (Grow) Capital Over Time</li></ul>
INVESTMENT STRATEGY:	<ul style="list-style-type: none"><li>• Opportunistic Capital Allocation – employing patient opportunism, which entails the following philosophy...</li></ul>
INVESTMENT PHILOSOPHY:	<ul style="list-style-type: none"><li>• Buy cheap assets (when available)</li><li>• Hold cash where there are no cheap assets</li><li>• Hedge the portfolio when appropriate</li><li>• Think creatively and opportunistically</li></ul>
IMPLEMENTATION:	<ul style="list-style-type: none"><li>• Security Agnostic – seek vehicles, assets, &amp; securities that best fit our needs (these include but are not limited to ETFs, equities, debt, derivatives, etc.), offer superior risk-reward, and if all else equal, lowest expense ratio, and greatest liquidity</li></ul>
RESULT:	<ul style="list-style-type: none"><li>• Absolute Returns</li><li>• Wealth Compounding Solution</li></ul>

## PORTFOLIO ALLOCATIONS

Below is the target allocation – what we believe to be the optimal allocation for the capital that we manage – as of the writing of this letter. Investor accounts may differ from this allocation due to changes in asset prices, available opportunities in the marketplace, and tax considerations.

- **Large-Cap High Quality:** 15% NAV  
Businesses with robust competitive advantages trading at ~5-10% earnings yield. Correlated with general equity market performance on the upside, while downside is usually less if/when markets reverse. These securities are very liquid so we can convert this allocation to cash at anytime and redeploy into opportunities when markets reverse
- **Large-Cap Financials:** 10% NAV  
Businesses with dominant market share trading at ~8-15% earnings yield. Fearful investors fled this area during and after 2008, and prices are still recovering. These businesses were the survivors, gaining market share, with profit margins that will greatly benefit if/when interest rates rise
- **Small/Micro-Cap Thrifts (with Catalyst):** 15.5% NAV  
Healthy thrifts generating 3-8% ROE, all are well-capitalized. We only purchase the ones trading at or below ~0.75x book value, and where ~10%+ of total shares are controlled by activist investors pressuring management to (1) cut costs, (2) buyback shares, (3) pay dividends, or (4) sell the business – providing catalysts for value realization
- **Small/Micro-Cap Banks (without Catalyst):** 13.5% NAV  
Healthy banks trading below book value with 3-8% ROE that are well-capitalized and growing loans, assets, and equity bases via reinvestment of earnings (compounding). In today's environment when everyone's cost of capital is ~0%, the cost of capital advantage of these businesses is not apparent. But if/when interest rates rise, these banks will experience significant profit margin expansion (what they earn on assets will increase while cost of liabilities stay near 0%)
- **Special Situations/Event-Driven/Other:** 21% NAV  
Public securities undergoing spin-offs, recapitalizations, liquidations, certain debt instruments, etc. The share price performance of securities in this category are often not correlated with general market activity, but instead tied to the unique catalyst(s) embedded in each position. This category will likely increase in the next few years given our preference for the “base-hit” and shorter duration
- **Cash:** 25% NAV  
This category will fluctuate depending on opportunities available in the marketplace. If suitable opportunities cannot be found, we are comfortable holding the present or perhaps even greater levels of cash

Certain allocations (such as Small Thrifts, Small Banks, and some Special Situations/Event-Driven names) serve as basic portfolio “padding” – akin to taking weightlifting in college for GPA credit (although one investor maintains that weightlifting was a difficult class). They set the baseline for attractive returns at relatively low levels of risk. This allows us to focus our remaining attention on improving the overall portfolio, by finding opportunities that provide superior risk-return profiles.

## PORTFOLIO RETURN ANALYSIS

Statistics for 2014 1<sup>st</sup> Quarter Portfolio\* returns:

- Number of winners (where we made \$): 31
- Biggest \$ winner accounted for 37.8% of total \$ profit & loss (“P&L”)
- Top 5 and Top 10 winners accounted for 82.8% and 101.4% of total \$ P&L, respectively
- Number of losers (where we lost \$): 14
- Biggest \$ loser accounted for -7.1% of total \$ P&L
- Top 5 and Top 10 losers accounted for -21.3% and -25.7% of total \$ P&L, respectively
- **Ratio of number of winner to losers (“Brag Ratio”): 2.2x**
- **Ratio of \$ profit to \$ loss (“Profit Ratio”): 4.7x**

Notice that the “Profit Ratio” (how much \$ we made when we were right vs. wrong) is greater than the “Brag Ratio” (how often we were right vs. wrong). We seek to maximize the Profit Ratio, not the Brag Ratio. As we wrote in our 2013 4<sup>th</sup> Quarter Letter:

“In a world that is overly focused on whether investors are ‘right or wrong,’ we prefer to judge ourselves instead by how much \$ profits we make when we are right, and how much \$ capital we lose when we are wrong. It is possible to make \$ profits by being ‘right’ less than 50% of the time (by upsizing your winners), just as it is possible to lose \$ capital by being ‘right’ more than 50% of the time (by upsizing your losers). Focus on portfolio construction and management, especially position sizing is paramount. We are not here to boast about how often we are right, but to maximize compounding and \$ profits over time.”

Our biggest loser declined 13% during the first quarter, and accounted for -7.1% of total \$ P&L. The security is a micro-cap thrift in which a well-known thrift activist investor controls ~10% of total shares outstanding. The thrift is well-capitalized, slightly profitable, and trades at ~50% of book value. We have taken advantage of the price decline by purchasing more shares, increasing the sizing of this position in investor portfolios.

Our biggest winner (also our largest position and last year’s biggest disappointment) appreciated 19% during the first quarter, and accounted for 37.8% of total \$ P&L. In the 2013 4<sup>th</sup> Quarter Letter, we wrote:

“All operating fundamentals remain strong at the company – the business is growing steadily and profit margins are expanding. We believe the key to unlocking price outperformance is predicated upon improving investor communication (i.e., how management conveys the ‘story’). We have already engaged the CEO in discussions related to this. Rest assured that this position is a top priority for us in 2014 – every \$ and % allocation has to earn its keep, by contributing to overall portfolio performance.”

In February 2014, we offered to help the company better convey its story by reworking the shareholder presentation; dialogue with management continues. Despite the recent price appreciation, the company remains undervalued at 0.72x book value (pro forma for reclamation of its deferred tax asset valuation allowance).

The remaining \$ gains came from a small group of winners:

- Senior note recourse to Kingsway (see Case Study Update section for additional details)
- Merger announcement of a Small/Micro-Cap Thrift
- Two substantially undervalued Small/Micro-Cap Bank positions (one remains undervalued at 0.63x book value, the other we are actively selling at 0.95x book value because it has approached our estimation of fair value)

## PORTFOLIO FUTURE POSITIONING

During the first quarter, we made the decision to decrease our allocation to Small/Micro-Cap Banks for positions near or at 1.0x book value.

In the aftermath of the 2008 crisis, investors fearfully sold any security with possible association to “bank” or “failure.” With passing time and short memories, valuations in the space have recovered. Banks we bought three years ago for ~0.65x book value now costs ~0.90x book value. This allocation has been spectacularly profitable, but the time has come for us to migrate toward greener pastures.

Some of you may wonder: “At ~0.90x book value and 3-8% ROE, there is still 15-30% upside remaining in these names, why sell them now?” Because upside potential versus probability of loss are not the only determining factors in how we make allocations. Investing is not a flat art; there are many other dimensions – many of them fuzzy and recursive in nature. Lately, the dimension foremost on our minds is **liquidity**.

### A Few Words on Liquidity

Before proceeding further into this discussion, it will be helpful to provide some background on how we think about liquidity, and the reason for its importance within the investment process. Below are quotes from Seth Klarman’s book *Margin of Safety*, Chapter 13:

*“...there is liquidity for the individual but not for the whole community...while any one investor can achieve liquidity by selling to another investor, all investors taken together can only be made liquid by generally unpredictable external events such as takeover bids and corporate-share repurchases. Except for such extraordinary transactions, there must be a buyer for every seller of a security.”*

*“In times of general market stability the liquidity of a security or class of securities can appear high. In truth liquidity is closely correlated with investment fashion. During a market panic the liquidity that seemed miles wide in the course of an upswing may turn out only to have been inches deep. Some securities that traded in high volume when they were in favor may hardly trade at all when they go out of vogue.”*

*“Since no investor is infallible and no investment is perfect, there is considerable merit in being able to change one’s mind...An investor who buys a nontransferable limited partnership interest or stock in a nonpublic company, by contrast, is unable to change his mind at any price; he is effectively locked in. When investors do not demand compensation for bearing illiquidity, they almost always come to regret it.”*

An investment's level of liquidity is determined by the ability to transition between it and other investments with minimal friction (e.g., transaction costs, wide bid-ask spread, time). The more illiquid the investment, the more difficult it becomes to change our minds when (1) mistakes are made, or (2) we notice a superior use for the capital elsewhere.

There is an opportunity cost associated with this inability to reverse course due to illiquidity. This is why investors should demand extra compensation (i.e., higher returns) before agreeing to bear illiquidity. How much extra compensation is adequate will vary based on the investor and circumstance – investing is, after all, a judgment business.

### Back To the Point

Small/Micro-Cap Bank securities are relatively illiquid. When purchasing at  $\sim 0.65x$  book value, we were compensated for bearing the illiquidity risk by high future expected returns ( $\sim 60-80\%$  over 1-2 years). At  $\sim 0.90x$  book value, the future expected returns are far lower ( $\sim 15-30\%$  over 1-2 years). We do not believe this is adequate compensation for the associated illiquidity risk. There are other securities in the marketplace offering comparable risk-return profiles AND abundant liquidity.

Additionally, we have observed an increase in the number of investors now willing to allocate capital to the space – in blatant contrast to three years ago when most investors considered Small/Micro-Cap Banks hazardously toxic. The arrival of this new “community” has been tremendously beneficial, bringing additional liquidity and lifting the prices of our existing holdings (as evidenced by the move from  $\sim 0.65x$  to  $\sim 0.90x$  book value). But the future is more worrisome as this area becomes increasingly crowded.



Because liquidity is often illusory, shifting based on market conditions and participant psychology, a “community” acting in unison has the ability to both create abundant liquidity, and exacerbate illiquidity. If/when this new “community” decides to depart, we believe its members will not be able to do so simultaneously due to the absence of incremental buyers.

Since we are no longer compensated for the illiquidity risk via high future returns, we are perfectly content to depart early (leaving 15-30% on the table), ensuring our exit via the stairs rather than risk the possibility of having to jump out windows. An early departure also minimizes opportunity cost(s) associated with illiquid positions because we retain our ability to redeploy this capital into superior opportunities that may appear elsewhere in the marketplace.

## CASE STUDY UPDATE

Last quarter, we featured a case study on a Special Situation / Event-Driven position (see reprint of full story below), a senior note recourse to Kingsway Financial Services (ticker: KFS), formerly an insurance company, presently a multi-strategy holding company with ownership in a variety of businesses operations.

We suspected that “management was purposefully not providing clarity” until after certain incentive compensations terms were solidified after December 31<sup>st</sup>, because the lack of information and clarity did not reconcile with our assessment of the CEO’s “shrewd understanding” of investor mentality.

Our suspicions were correct. Soon after incentive compensation terms were finalized in early 2014, the company announced a flurry of activity, including:

- IPO of a property casualty insurance subsidiary (Ticker: PIH)
- IPO via SPAC of a merchant banking subsidiary
- Publication of a Buffett-esque annual letter aimed at seducing value-oriented investors, containing clarification on restructuring efforts, underlying businesses, and long-term goals (<http://www.sec.gov/Archives/edgar/data/1072627/000107262714000028/ex99103-31x14.htm>)

The price of the senior note and common equity appreciated in the aftermath of these announcements. We continue to own both securities in the Kingsway capital structure (combined, ~15% of portfolio NAV).

Reprint of Kingsway Case Study from 2013 4<sup>th</sup> Quarter Letter:

Recently, while browsing headlines related to “rights offerings,” we came across an insurance company dual-listed on the NYSE and Toronto Stock Exchange. The company is controlled by a group of activist investors (the main one is familiar to us, and an honest individual who is unlikely to enrich himself at the peril of other shareholders).

### The Complicated Situation

The company has NOLs (generated from historical losses under another management team no longer present) ~11x the size of its current equity market capitalization. A restructuring effort – shuttering unprofitable businesses, reinvesting in new businesses – has been ongoing for a few years.

The recent rights offering (during which the activist investors and management team all oversubscribed for their pro-rata allotment) is part of the Company’s strategy to increase its capital base to better and more quickly take advantage of its large NOLs. (Here’s the logic: Larger \$ capital base → greater \$ profits → faster \$ NOL utilization to offset current taxes → higher annualized return for shareholders.)

What seemed merely mildly interesting became extremely interesting once we read the incentive plan for management, which was buried in the proxy statement. After the rights offering, “certain officers” would be awarded restricted shares (vested over 10 years) equal to 3 times the number they held in shares and warrants at the end of an “accumulation period” on December 31, 2013. This is very rare and different from the usual fare of corporate compensation packages. And in our opinion, a vital clue when combined with and viewed in context of the entire story.

**Reading through the filings, there seemed to be assets and progress made on the restructuring. What was blatantly lacking was clarity, something that did not match with the CEO's shrewd understanding of what information investors require before investing. Combined with the unique terms of the incentive plan, it sparked our suspicion that management was purposefully not providing clarity until after the "accumulation period."** Lo and behold, in January 2014, the Company filed a prospectus to take public a subsidiary that in the 2012 annual report received only a few mentions.

#### Long Story Short

The Company has a 5% annual coupon senior note (held via trust with a total return swap component) due June 2015 trading for 80% of par value on the Toronto Exchange. The Company has already repurchased 75% of the total issuance. There is very little float remaining and the security is considered an "odd-lot" by industry standards. Large investors would not bother with this security given the limited liquidity, while smaller investors usually lack the ability to figure out the complicated situation at the company level.

Supported by assets on the balance sheet plus the cash infusion from the recent rights offering (much of which was contributed by management and main activist investors), we believe this senior note is most definitely worth par. It is due in June 2015, which provides us with ~30% total return, ~20% annualized return. We are currently buying as much as we can source in the open market, and would be comfortable making this a significant portion of the portfolio.

This security encompasses both the "short duration" as well as "base hit" components of our previous discussion. It is no home run at ~30% total return / ~20% annualized return, but a relatively low-risk way to stay satiated while we wait for better opportunities in the future. It is also a great example of the advantageous nature of our small size, which allows us to traffic in securities that slip through the cracks, overlooked by our larger competitors, and too complicated for other investors of smaller size.

These letters serve as a general medium through which we communicate with our investors. For any account specific questions, or anything else that's on your mind that you'd like to discuss, please do not hesitate to contact us directly.

Yours very truly,

Vivian Y. Chen, CFA  
Portfolio Manager  
Marram Investment Management LLC



## APPENDIX: HISTORICAL PERFORMANCE RETURNS\*

2011													
	2011	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Marram	24.74%	6.11%	3.39%	2.16%	3.62%	2.00%	-1.40%	-0.39%	3.52%	-0.66%	1.84%	1.81%	0.55%
S&P 500	2.11%	2.37%	3.43%	0.04%	2.96%	-1.13%	-1.67%	-2.03%	-5.43%	-7.03%	10.93%	-0.22%	1.02%
% Cash Exposure		7.47%	11.92%	13.46%	15.42%	13.54%	30.64%	23.14%	21.93%	12.17%	11.78%	10.51%	7.95%
2012													
	2012	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Marram	37.35%	3.12%	6.15%	7.05%	3.14%	0.54%	1.45%	0.59%	0.60%	1.46%	4.55%	1.63%	2.13%
S&P 500	16.00%	4.48%	4.32%	3.29%	-0.63%	-6.01%	4.12%	1.39%	2.25%	2.58%	-1.85%	0.58%	0.91%
% Cash Exposure		9.69%	8.43%	11.20%	7.58%	10.57%	8.83%	16.43%	26.99%	22.73%	27.11%	25.32%	21.86%
2013													
	2013	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Marram	29.77%	5.38%	1.80%	4.38%	2.48%	2.78%	1.63%	3.60%	1.42%	1.30%	-0.45%	1.80%	0.38%
S&P 500	32.39%	5.18%	1.36%	3.75%	1.93%	2.34%	-1.34%	5.09%	-2.90%	3.14%	4.60%	3.05%	2.53%
% Cash Exposure		19.45%	17.58%	19.53%	17.45%	22.78%	16.78%	10.50%	6.81%	4.61%	4.87%	6.31%	9.02%
2014													
	2014 YTD	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Marram	5.13%	-0.41%	3.22%	2.27%	-	-	-	-	-	-	-	-	-
S&P 500	1.81%	-3.46%	4.57%	0.84%	-	-	-	-	-	-	-	-	-
% Cash Exposure		7.88%	5.10%	9.45%	-	-	-	-	-	-	-	-	-

\* Unaudited, gross return figure, before fees. Performance is derived from the portfolio manager's separate account. Returns for each separate account may differ due to fund transfer timing, order timing, tax considerations, and other account restrictions. Returns presented for S&P 500 include dividend reinvestment.

Disclaimer: An investment is speculative and involves a high degree of risk. Past performance return is not a guarantee for future returns. Investors are urged to consult a professional advisor regarding the possible economic, tax, legal or other consequences of entering into any investments or transactions described herein.