



The performance of the Ensemble Fund (“the fund”) saw a reversal of our weak performance in the first quarter. Two of the three stocks that had underperformed in the first quarter rallied strongly, while the balance of the portfolio modestly outperformed the market. The fund’s performance was up 5.66% vs the S&P 500 up 3.09%. We finished the first half of the year with the fund up 9.60% vs the S&P 500 up 9.34%.

As of June 30, 2017

	2Q17	1 Year	Since Inception*
Ensemble Fund	5.66%	24.19%	11.25%
S&P 500	3.09%	17.90%	11.29%

*Inception Date: November 2, 2015

Past performance does not guarantee future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance data quoted. Performance data current to the most recent month end are available by calling 1-800-785-8165.

L Brands (7.2% weight in portfolio) had the largest positive impact on performance. After the market turned deeply skeptical in the first quarter of the company’s ability to sustain and grow sales in the face of Amazon seemingly eating all of retail, actual sales results were better than expected leading to a strong rebound in the shares.

TransDigm Group (3.8% weight in portfolio), which had declined in the first quarter after a short seller leveled fraud accusations against the company, accusations that we do not believe are credible, recovered its losses and rallied to a level 10% higher than when the accusations were first made. While the accusations have not been disproved, we continue to think they are misplaced and it seems the market has come around to our point of view. We did trim our position in the company somewhat after it recovered. While we do not agree with the fraud accusation, the significant research efforts we engaged in after the accusations were leveled caused us to reduce our assessment of the fair value of the stock to some extent for reasons unrelated to the accusations.

The two largest drags on our performance were National Oilwell Varco and Discovery Communications. We exited both positions during the quarter.

National Oilwell Varco is the leading maker of high-end oil rigs. Analysts joke that the company’s ticker symbol (NOV) stands for “no other vendor”. When we first researched National Oilwell, we believed that the company would maintain its dominant position in supplying global rig equipment and that the number of active rigs would increase over time. Despite the major cyclical downturn in active oil rigs, we still believe that both of these assumptions are correct. However, we underappreciated the degree to which the mix of rig types being sold dramatically impacts the company’s profitability.



For instance, while the rig count has been rebounding, the increase has mostly been land-based rigs, which cost much less than ultra deep water rigs. As the industry rebounded from the dramatic declines seen in 2015, we came to the conclusion that we were unable to accurately forecast the mix of rig types that will be needed in the years ahead. Because of the demand for different types of rigs, not just the total number of rigs, is a key driver of National Oilwell's long-term earnings power, we no longer believe we can adequately forecast the company's ability to generate cash on behalf of shareholders.

National Oilwell still has an enviable set of competitive advantages that we believe will allow the company to maintain dominance in the markets it participates in. But we've lost confidence in our ability to assess how much cash flow the company can generate from these markets.

We exited Discovery Communications for different reasons. When we bought the stock in 2015 we believed that the company's popular nonfiction video content was ideally positioned to leverage the global distribution capabilities of streaming technology and would profit even as streaming video conquered the traditional cable TV bundle. What many investors forget about streaming is that content is still king and consumers are watching even more high-quality video content today than they were before streaming became common.

We agree with John Malone, one of the great executives and investors in the media industry, that the big opportunity in media today is the ability to leverage high-quality content and sell it on a global basis rather than being limited to geographically constrained cable TV networks. Discovery is unique in publicly traded media companies in that over 50% of its revenue comes from outside the US. While a show like *Stranger Things* might be very popular in the US, these sorts of shows are often not hits on a global basis and so they cannot fully exploit the global potential of internet distribution. But Discovery's nonfiction content often has global appeal. The flagship station's *Shark Week* series has the potential to interest people from the US to South Africa to China and Russia.

However, as we've watched streaming video go mainstream, we've noticed a critical change in viewer behavior that we think will reduce viewership of Discovery's content. During the linear cable TV era "channel surfing" was typical behavior and Discovery's documentary and reality TV content often held enough interest for viewers to stop and watch. But with streaming TV, viewers are far more proactive in their viewing habits. Today, content must cause enough buzz, often on social media, for the viewer to learn about it and then proactively choose to search for the show.

While Discovery's mix of shows was great "filler" content that would entertain viewers who were flipping channels after dinner looking for something to watch, it is not buzz worthy content that we believe viewers will proactively search for in an era where there is an abundance of on demand, high-quality content available at any time of day.

The economic data that was released in the last quarter generally supported the idea that the economic conditions that have been in place for a number of years continue to persist. However, what has changed is a broad increase in the market valuation of US stocks. While the S&P 500 has increased in price by 18% since the end of 2014, the earnings of the companies that make up the index are essentially flat. This has led the PE ratio to go from 18 times to over 21 times and has caused many people to worry that the market is overvalued.



At Ensemble, we do not believe that there is an effective methodology for investors to accurately determine if the market as a whole is over or under valued in a way that allows them to act on this information to generate superior returns. Those who think the market is overvalued tend to point out that the current PE of 21 times is more than 30% higher than the average PE of 16 to 17 times that has been observed for the past 60 years. However, valuation is not a static concept. There is no law that says that the average valuation of the past 60 years will be the average valuation over the next 60 years. The fair value PE ratio is a reflection of how much growth potential a company has, how much cash flow a company generates per dollar of earnings and the company's cost of capital.

While many people believe that growth in the years ahead will be lower than it has been in the past, we can also observe that cash per dollar of earnings has increased over the years for S&P 500 companies as returns on capital have increased, while the cost of capital has fallen with lower interest rates. Since the S&P 500 is made up of a changing mix of companies, it is possible that the companies that make up the S&P 500 today deserve higher PE ratios than the average company that made up the S&P 500 over the past 60 years.

Indeed, while the average PE ratio of the S&P 500 over the past 60 years has been 16 to 17, the average PE over the past 30 years has been 19. So an important question for investors to answer who seek to cite the PE ratio of the market as evidence of that it is over valued is whether it is appropriate to assign as much weight to the average PE ratio of 14 that persisted from the mid 1950s to the mid 1980s as they do to the average PE ratio of 19 that has persisted from the mid 1980s to today.

If the last 30 years is a more valid assessment of the fair valuation of the market than the previous 30 years, then today's PE of 21 is still slightly above average, but close enough to the average that it is not statistically meaningful. Indeed, the market has traded at PE ratios above 21 in almost half of the past 30 years.

Why might this be the case? Well, one large difference between the S&P 500 of today and the index of over 30 years ago is the shift in the largest companies within the index from energy and financial companies, which rightly trade at moderate or even low PE ratios, to technology companies which rightly trade at higher than average PE ratios.

By "rightly" we mean that the leading technology companies of today are growing faster and generate higher returns on capital than did the financial and energy companies of many years ago, and basic valuation math shows that these characteristics confer higher fair value PE ratios.

Now the idea that tech companies deserve high PEs as a way to justify high market level PEs will remind investors with any sense of the history of the Dot Com bubble. But the valuation of tech stocks today bears no resemblance to the bubble.

Today, technology stocks trade well below both the average and median PE ratio for tech stocks over the last 30 years and in fact the S&P 500 technology sector trades at a more than 10% discount to the market as a whole.

Instead of high PE ratios for individual tech stocks driving up the market PE ratio, the market cap of technology stocks has become a much bigger component of the market than it was in the past and since



technology stocks deservedly trade at higher PE ratios than other sectors, this shift has deservedly increased the average PE of the market as a whole.

No less a value conscious investor than Warren Buffett commented on this shift at the most recent Berkshire Hathaway annual meeting, where he pointed to the fact that the largest companies in the S&P 500; Apple, Microsoft, Amazon, Facebook, and Google generate far more cash per dollar of earnings than companies of the past. Buffett even went so far as to say that he'd like the holdings of his portfolio to look more like these companies, a sentiment he certainly never expressed during the Dot Com bubble.

Now, none of this means that we think the market is not overvalued. Maybe it is. It just means that there are plausible arguments to be made that the market is fairly valued or even cheap. But at Ensemble, we don't think that making this determination is possible or necessary. We believe that many companies face so much uncertainty about their future that it is not possible to make a reasonable assessment of what they are worth. So we simply don't own those companies.

Instead, we limit our holdings to just 15 to 25 companies that we feel we can make a reasonable assessment of their fair value and which currently trade at a discount to that valuation. In any market, even during bubbles, there are always stocks trading at a discount. So long as we only focus on owning those stocks, we don't think we need to spend much time contemplating whether the market as a whole is over or under valued.

That being said, we do note that today we are finding it more difficult to find high quality, competitively advantaged companies that trade at a discount than we have for a number of years. While the fund is still relatively fully invested, we rate a larger than average number of positions as Holds rather than Buys. This means that as cash enters our the fund, either through new deposits or us trimming existing holdings, we are not fully investing the proceeds and so cash levels have begun to build. But far from being a call on the market, this cash is simply the residual of our decisions on individual stocks. Rather than waiting for a pullback in the market, this cash will be put to work when we complete research identifying new stocks with investment potential or when stocks in our portfolio in which we do not currently have a full position decline to more attractive levels.

While we don't make investment decisions based on how the market as a whole is trading or even the underlying sectors, we do think it is notable that today approximately 80% of the fund holdings are members of the Technology, Industrials, and Consumer Discretionary sectors and that each of these sectors are currently trading below their average PE ratios over the past 30 years. While this fact is not the reason why we own these stocks, it does show that the companies in our portfolio are members sectors that are trading at historically cheap valuations, even while the market as a whole is trading at a level above its historical average.

Company Focus: Ferrari (RACE) and The Advisory Board Company (ABCO)

RACE (1.5% weight in portfolio): Ferrari manufactures super cars that are specifically made to cater for the pleasure of drivers and collectors at the top end of the automotive food chain, those in the



top 0.1%. Its cars are luxury goods that are inspired and derived directly from the Formula 1 race cars the company designs, builds and races through its Scuderia Ferrari racing team.

Ferrari's cars are anything but practical cars – they are race-inspired expressions of something about their owners, who are among the elite few that are able to possess and experience one of their machines. It is a purely luxury item that is either the fulfillment of a dream, a statement that you have arrived, are a passionate auto aficionado, or that you are free.

Ferraris are more about the emotion, the passion, and the experience than they are about transportation. The sound, the speed, the F1 racing legacy, and the conspicuous shapes are all part of the experience that comes with owning and driving a Ferrari.

Ferraris are an entirely discretionary purchase, akin to other luxury good items like high-end handbags, watches, jewelry or art. All of these serve a more abstract purpose outside of the semblance of utility their exact form may indicate.

Its brand and reputation were born of F1 car racing when its founder and race car driver turned businessman Enzo Ferrari founded his own racing team and race cars in 1945 then later decided to sell a few of his race inspired cars to help fund his racing ambitions. That DNA and reputation have helped carry the brand to its place today, as an expression of the limits of what a car can achieve with a distinctively Italian design flair. From the core of its performance capabilities to the way it looks, and sounds, and ultimately how it makes its driver feel about himself or herself, the cars that Ferrari builds are an experience built on a long legacy and culture of racing, passion, and winning.

Of course, we haven't mentioned a very important aspect of owning a Ferrari — that is being part of an exclusive club. There have only been 7-8K Ferraris sold globally in each of the last 5 years. In order to buy the latest high-demand Ferrari or a limited edition supercar, you have to own one or more Ferraris first. In other words, being able to afford one does not entitle one to actually buy one. 2/3 of new Ferrari buyers are repeat buyers, at an average price of \$250K-\$1MM+. These are incredible statistics that bode well for the makings of a highly profitable and defensible business.

To get a sense of how limited Ferrari's cars are, in 2016, there were 1.3 million individuals in the US with a net worth over \$5 million and only 2700 Ferraris allocated to the US. So only 2 out of every 1000 of these individuals could actually buy a new Ferrari. Of course, many of these folks couldn't care less about a Ferrari, but it goes to show the relative scale of potential buyers to available cars. The company actively cultivates a supply-demand imbalance in order to preserve the value of both new and used Ferraris thereby creating scarcity value. This is a tactic that many other luxury brands employ as well, including luxury hand bag brands like Hermes (RMS FP) and Swiss watch makers to create both an aura of exclusivity among their customers and preserve the value of their products.

All of these examples comprise a category of goods referred to as Veblen Goods. These are products whose attractiveness to their consumers actually increases as their price premiums increase, in contrast to the economic principle that applies to most goods that demand increases as price decreases. This increasing price tactic is offset by the ability of numbers of consumers who can



actually afford to buy their goods despite their increasing desire to buy them. And that is where the supply/demand and pricing balancing act comes in.

In fact, when it comes to its very limited edition supercars like the LaFerrari, Ferrari's million dollar plus sale prices still leave a lot of money on the table for its elite cadre of customers who see the resale value of their cars rise to multiples of their purchase price. The LaFerrari went into production in 2013 with the limited run 499 vehicles that sold for over a million dollars each. Resale values were in the \$3MM range immediately after they went into production and more recent sales indicate a value of \$5-7MM just a couple of years after production ended. It's no surprise that the two most expensive cars ever sold at auction are both Ferraris as are 7 of the top 10 and 15 of the top 20! This phenomenon is a huge contrast to the price of 99% of cars, whose value declines the minute you drive it off the lot and continues to do so every year thereafter.

The strong brand and experience is at the heart of Ferrari's moat and drives the underlying economics of its very profitable business. It is also what points to our analogy of comparing Ferrari collectors to art collectors with price appreciation dynamics that accompany the limited run pieces.

As a result, Ferrari shows an exceptional return on invested capital of ~100% with the very little incremental capital required for it to grow its business at the rates it targets, in the 5-10% range. The low capital intensity results in strong free cash flow generation, which is at the heart of any company's long term value. Finally, it's 12-18 month waiting list and its deliberate strategy of undersupplying its market demand make it highly resistant to declines during recessions, adding predictability and resiliency to its business model.

By comparison, the average S&P 500 company has about a 10% return on invested capital. Incredibly, Ferrari's return on invested capital is in the same league as high IP content, asset light companies such as Apple (AAPL: 4.6% weight in portfolio), Alphabet (GOOGL: 3.9% weight in portfolio) or MasterCard (MA: 7.1% weight in portfolio). Most analysts compare it to high margin, highly valued consumer luxury goods companies like Hermes (RMS FP), Richemont (CFR VX), and LVMH (MC FP) instead of the traditional capital intensive, cyclical, low P/E automakers for the same reason.

Just like Paychex (PAYX: 7.1% weight in portfolio, a company we've discussed in a past conference call, we believe the high sustainable return on invested capital coupled with strong free cash flow generation entitles Ferrari to a much higher than average P/E multiple in the high 20's, despite the fact that it is not a super-fast growing company. If you are interested in learning more about Ferrari and how we view its valuation, we invite you to read our blog post published in May on the Intrinsic Investing website titled "[Tesla vs. Ferrari – What RACE and TSLA Tell Us About The Winning Formula For Stocks](#)".

ABCO (4.7% weight in portfolio): The Advisory Board Company stock has doubled since March of this year. As we described in [our blog post about the company](#) written at that time, Advisory Board provides software and consulting services to help hospitals reduce the cost of health care while improving patient outcomes.



The US health care system is fundamentally inefficient to a degree far out of step with the rest of the world. While Americans pay 50% more per capita for health care than the best in class health care system provided in Switzerland, the life expectancy here is as low as that seen in Chile and the Czech Republic, who spend 75% less per capita than we do. As you can see in the chart we published in our post on the company, health care systems around the world fall on a curve that neatly describes the relationship between per capita spending and life expectancy. The US is the only country where this relationship between spending and outcomes is fundamentally broken.

Earlier this year, market participants sold Advisory Board stock down to its cheapest valuation in history outside of the 2008-2009 financial crisis. Investors were concerned by the slowdown in Advisory Board's revenue growth and worried that the company's significant push into providing services to higher education institutions was a mistake, despite education suffering from similar issues around weak student outcomes in relation to runaway costs.

As with all of our assessments of a company's fair value, we focus on cash generation. Both of Advisory Board's businesses generate outstanding levels of distributable cash flow even while offering long-term growth potential.

Earlier this year, the activist investment firm Elliot Associates, run by famed hedge fund manager Paul Singer, recognized the disconnect between Advisory Board's public market price and the actual intrinsic value of the business. After taking an 8% position in the company, Elliot Associates pushed the company to sell themselves, likely splitting up the education and health care business to two separate buyers. The stock has been rapidly appreciating ever since, rallying over 10% last week as Bloomberg reported that United Health was emerging as the leading bidder for health care while private equity firm Vista was the most likely bidder for the education business. With earlier reports suggesting over 20 bids had been submitted for the company, it seems clear that no matter what price the company ends up selling for, or even if a deal falls through, Advisory Board is a company with a significant intrinsic value that the market has underappreciated.

We sometimes use the phrase that we bring a "private equity approach to public market investing." This simply means that we make investment decisions not as stock analysts seeking to guess which way the stock will move, but as business analysts seeking to understand the economic value of the companies we analyze. We believe that over time, public markets value stocks on the same basis as private markets do. In this way, markets are efficient over the longer term.

But in the short term, public markets often misprice stocks relative to pro rata ownership in the company they represent. This is what Benjamin Graham meant when he said that "In the short run, the market is a voting machine but in the long run it is a weighing machine."

Investors should consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. You may obtain a prospectus at www.EnsembleFund.com or by calling the transfer agent at 1-800-785-8165. The prospectus should be read carefully before investing.



An investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. There can be no assurance that the Fund will be successful in meeting its objectives. The Fund invests in common stocks which subjects investors to market risk. The Fund invests in small and mid-cap companies, which involve additional risks such as limited liquidity and greater volatility. The Fund invests in undervalued securities. Undervalued securities are, by definition, out of favor with investors, and there is no way to predict when, if ever, the securities may return to favor. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. More information about these risks and other risks can be found in the Fund's prospectus. The Fund is a non-diversified fund and therefore may be subject to greater volatility than a more diversified investment.

Price to Earnings (P/E): This is a valuation metric that normalizes a company's stock price to the earnings per share they generate. This metric doesn't work if the earnings of the company is negative.

Cost of Capital: The capital structure of a company is made up of equity and debt. Each of these components have a cost to the company. For example: if the company went to a bank for a loan, the bank might charge them an interest rate of 5% on the loan. That 5% is the cost of that capital (debt).

Return of Capital: This is the repayment of the original investment. For example: if a company borrowed \$100,000 from a bank with a 5% interest rate for 1 year. The repayment at the end of the year would be \$100,000 (return of capital) plus \$5,000 (interest).

Return on Invested Capital: This is a ratio showing every dollar that is spent on investments (inventory, new factory, etc) and the additional level of earnings can be expected in the future from that investment.

Free Cash Flow: This is the excess cash that the business generates after it pays all of its bills and current obligations to operate the business.

Fund Fees: No loads; 1% gross expense ratio, 2% redemption fee on shares held 90 days or less.

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