

Dennis: Thank you, Mark. I, too, would like to show our great appreciation for Mark and his staff and what they done today— it was a great day. Although Mark did not tell me we'd be following a British knight, so next time maybe give us a little warning there, but great job, Sir Martin.

During our presentation today Arik and I will discuss the FPA Capital Fund. Arik will talk about the Capital Fund's highlights, our investment process, some of our recent challenges that have led to our underperformance, and then he'll go over a few of the opportunities that we've seized on as we've gone through this rough patch. I'll then come back up and talk a little bit about the energy markets. With that, I'll turn it over to Arik.

Arik: Thank you, Dennis. Thank you very much for joining us. It's a wonderful event and it was especially interesting to me last night, because two separate investors came to me and they reminded me that they had been investors from day one. That's 31 years, so I really appreciate that. And one of them actually, in our last investor day, gave me a little fund directory of FPA from, I think, 15 years ago and there were 10, 20 names on that list. (49:33) And I'm also really proud to say that quite a few of those people on that list are still working for our firm today. And it's the combination of the two; the longtime shareholders and a stable firm that

allows us to really focus on what really matters, which is generating robust long term performance.

Maybe I can tell you a little bit about this fund. FPA Capital has been around for the past 31 years and my co-manager Dennis has been with the fund since 1993 and I joined in 2010. We are a long only Absolute Value Fund that is benchmark agnostic. We look for market leading companies with a history of profitability and sound balance sheets and good management teams. Once we identify and research these companies we buy when there is a compelling risk to reward ratio. (50:29) The resulting portfolio tends to be concentrated with—it ranged from 20 to 40 names but our sweet spot has been 25 to 35 names and our holding period is seven-plus years. Both Dennis and I are large shareholders alongside you in the Fund.

I'm going to talk a little bit about our process. I know it's a little bit of a busy slide, but I'll start right here. This is how we come up with the list of companies that we're interested in. That's step number one. And we do that by attending conferences, meeting different management teams, reading industry journals and we run our screens. And the resulting list will start the research. And research has two different parts. We have to put it [the company] through a rigorous analysis and we going

to first try to understand what the business is about. Our goal is to understand how a business makes money and what are some challenges that they might face that will cause them to lose money. (51:30) And we start with the source documents. We read the annual reports, we read their transcripts, we read some research reports, look at their investor presentations and we really try to understand what ticks a business. Then by reading these, we coming up with hypothesis; this is how they make money, this is how they lose money.

The next step is to go and to test this hypothesis. In order to test this hypothesis, we start talking to people who understand the industry and the business better than we do, so we'll talk to the management team. We'll talk to their competitors and we'll talk to their suppliers, their clients. We talk to industry experts, all trying to understand if our hypotheses were right, and if they were not right, what other ways can we really improve our research.

Once we understand the business we calculate our estimate of the intrinsic value of the company, and that intrinsic value is going to be based on the cash earnings, what we call normalized earnings, cash earnings of a company. (52:30) Then we go through scenario analysis, because we are going to make mistakes and we are going to think about

the reasonable downside case scenario, and then we are going to compare our upside case to our downside case, and if there's a compelling risk to reward ratio, we'll be interested in investing in the company. The resulting portfolio will have only our highest conviction names. But the buy and sell decisions is really only one part of the decision. Our holding period is seven-plus years so that means that we have to spend quite a bit of time to continuously monitor these companies, because over a seven-year period, clearly companies change and they evolve. And I would say that our team spends more than 50, 60 percent of its time continuously learning about the existing portfolio and existing names, and the rest of the time we spend in order to come up with new investment ideas.

Here is our performance since inception and all the regular numbers that you always see. (53:31) Our performance has been very poor since the fourth quarter of 2014. The cumulative effect of this performance of five straight quarters itself ended up resulting in weak long term numbers. As we mentioned before, the multi-year performance numbers are very end point dependent, and we believe that we can improve them substantially as quickly as they deteriorated. As disappointed as we are with the short term results, we are actually

optimistic about the future. And I'll tell you why we are optimistic about the future. We are optimistic because our process has not changed. The majority of the reason of underperformance happened in a short period of time and we are finally seeing some opportunities and we are taking advantage of these opportunities.

Let's talk about the process because this is the most important part of the investment cycle. (54:25) Our portfolio always looks at market leading companies with a history of profitability, strong balance sheets and good management teams, and we only buy them when the stock is cheap. If you look at our price to earnings ratio and price to book ratio and compare it with the Russell 2500 Index, you will see that we have a great valuation advantage. Keep in mind that this price to earnings ratio is based on last 12 month earnings, which are very depressed for a meaningful part of our portfolio. As you can imagine, our energy names have been not earning to their potential and that depressed their earnings.

The balance sheets are very strong. We have only very few companies that have any type of maturity within the next five years, and if you look at the yield to maturity you'll see the numbers are low, which means that the market thinks that these companies are not at risk. As I mentioned, the majority of the hits happened in two quarter period. (55:27)

You see here our negative performance versus Russell 2500's continued some performance during the fourth quarter of 2014 and first quarter of 2015. During this time period all prices went down by 50 percent during this two quarter period, and you see our top five contributors—or maybe bottom five, I don't know how to say it—but they accounted for nine percent underperformance. We have, as you can imagine, carefully analyzed our mistakes and we're trying to understand are we making more mistakes today than we have done in the past. And we see that okay, we were wrong with energy and the timing of it, then we were hit with two investment in for-profit education which was then followed by our two largest technology investments going through transformative acquisitions which we believe, at least in the short term, depressed their share prices. And it does not appear that we are making more mistakes but that those mistakes, similar types of mistakes happened in the past, but the fact that all three happened at the same time is really a rare event.

(56:33)

We are, though, taking advantage of these opportunities. You can see that from Q3, 2014 to the end of the first quarter, oil prices decreased by about 65 percent and we continued to buy during this downturn. You can see what we did by looking at this chart. We are going to use change

in weightings [to depict] what we did during this period. So as I said, the price of oil, which is gray, is a proxy of what happened to energy stocks, and we are going to use our total weighti of these and the change in weightings[to show] what we did during this period. So as I said, during this time period oil prices went down by 50 percent, but our allocation only changed by 20 percent. In Q1 '15 oil prices continued going down but we actually increased our position. You might recall that there was a small quick lift increase in Q2 '15. (57:27) Oil prices moved up a lot and at that time we took advantage of that increase and we decreased our allocation to energy. You see Q3 and Q4, we increased our allocation and you see that actually energy stocks are not doing well and that's the time we're increasing our allocation. And Q1 '16 was really an interesting quarter and provides a really good case study on how we take advantage of these opportunities.

Here you're seeing price of oil at the end of the year was about \$37, and it closed the first quarter at around the same price, around \$37, so if you just look at the end of year price and on the first quarter price, you would think that nothing has changed in the world, oil prices did not move at all. But as you all know, oil prices hit \$26 in the first half of February. Here is a stock that we own called SM Energy Company.

(58:25) Beginning of the quarter, stock price is a little bit over \$18. At the end of the quarter, stock price is a little bit over \$18. Again, if you just look at those two data points you will think that nothing has happened for this company, but during the quarter, the stock broke \$10 and stayed below \$10 for a few week period.

Let's look at our ownership of SM Energy Company. At the end of the year we had about 800,000 shares of SM Energy. At the end of the quarter we again had only 800,000 shares of SM Energy for the Fund. You would think that we did not do anything with this company but the reality is very different. When the price of the stock was going down, we actually increased our position by 50 percent during the quarter. We bought about 400,000 shares. And once the stock price started going back up again, we sold almost all the new shares that we bought, which ended up saying that we had no change within the quarter and we actually ended up buying 400,000 shares and selling about 400,000 shares.

(59:32) And these are our buys and sells. Even though you would think that nothing has changed, our average [buy] price was about \$11 and our average sell price was about \$16.50.

Today we have 25 names in the portfolio. On this chart you can see we have been very active. When you have a 25-name portfolio and

our average holding period is seven years, if you divide 25 to seven you will see that every year you should expect us to buy and sell three to four companies on average, and this was definitely no average year. We ended up initiating seven new positions. Two of them are actually high yield positions that we have done in the past but not in a long time and we also eliminated a number of positions and almost every other name we either had a net increase or net decrease in the number of shares we had in the stock.

And finally, I will talk about how the portfolio looks today. (1:00:29)  
You can see here the largest allocation is technology at 26 and a half percent, and energy you have to add these two up; it's about 22 percent. And we go where the opportunities are. Just because you see technology here and energy here today doesn't mean that the future is going to be similar. It might be or it might not be. I'll tell you that consumer and retail made up about 40 percent of our total portfolio in early 2000s, and now they stand at only four percent of the portfolio. We used to have 17 percent exposure to financials earlier in the decade of 2000, and then we have none today. What's really interesting is when you look at it historically, our top ten holdings throughout the years tend to make up about 50 percent of the portfolio and our exposure to two largest

industries continue to be little bit over 50 percent of the portfolio. With that, I'll turn it over to Dennis. (1:01:24)

Dennis: Thank you, Arik. I appreciate it. Okay, my discussion here today is going to be about the energy sector. Given the energy sector's large contribution, as Arik mentioned, to our underperformance, the large weighting we have in the fund that was allocated to this sector and the debate that's going on right now today, whether oil prices will soon head back down to \$30 a barrel, we believe it's useful for you to understand how we think about this sector. During my presentation we're going to show you a couple slides that we've used in prior webcasts. We're using these merely to show you what we said back then and what's transpired since those webcasts. Okay, with that out of the way, let's get started.

This is a slide that we used in Q4 2014 and it's a busy chart, but I want you to focus kind of on this wormlike figure, and that is the marginal cost of production for oil. (1:02:32) And there's a description down here what we have for the marginal cost of oil. And our thesis is just like any commodity and what we've learned in micro econ classes is that a commodity price will tend to revert or hover around its marginal cost of production. On the call, you can see here we highlighted \$85 a barrel and the green line is the actual price of oil over many years, over the last 25

years or so. Now, the blue line is the cash cost. What we stated in the fourth quarter of 2014 is we believed the price of oil would eventually revert back to \$85 and we also said at the time we didn't think oil prices would sustain itself below \$30, its cash cost. (1:03:27)

Here's another view of the marginal cost of production and this comes from the International Energy Agency or the IEA, and it's their look at the marginal cost production throughout the world, and what they have is the various basins around the world. Now, however, what you'll see here is that it only goes to 85 million barrels a day. The world is actually consuming 95 million barrels a day. The gap is largely explained by ultra-deepwater, which is around \$80 a barrel for the international oil companies to get economic return.

Okay. Now we've been asked oftentimes, what's driving oil? (1:04:25) What is kind of the key factor behind the price of oil? This chart goes back nearly 50 years and on here you can see M2 and the price of WTI. It's a very intuitive slide because oil is actually priced in US dollars around the world. Some countries don't want the dollar but they'll actually use the US dollar as a reference currency to actually set the price for their transactions. And over time as the Federal Reserve has increased the M2 or the money supply, you could see the prices will kind of trend up.

The R<sup>2</sup> is 80 percent. It's a very high R<sup>2</sup>. What's interesting here is you can see some dotted lines. This is one standard deviation below the mean and this is one standard deviation about the mean. (1:05:26). And over the last nearly 50 years the price of oil has tended to stay within that range, within that band, except for a couple rare occasions. Back in early 2008 it spiked up, but it quickly reverted right back down to the mean and actually below the mean. But you can see on many occasions it hit this one standard deviation but never really fell below until this most recent period. The question is why. Now the last thing I will say on this slide is the band, this upward band trajectory of oil, this price right here is \$70—this is \$120 and the mean is \$95. When we underwrote our energy investments we looked at the marginal cost of production and then we felt that looking at this over history, we felt our downside was \$70. We were wrong on that. (1:06:24) And it's the first time the price actually went below that band.

Okay. Just like on the Bernstein slide, we used this slide also in the Q4 2014 conference call or webcast for Capital Fund and we supported what Bernstein was suggesting, that the cash cost was around \$30 and prices probably wouldn't go much below that, and in this slide here you could see why we felt that way. You would have nearly six

million barrels of oil that would be uneconomic at the cash level; not the all in cost, just at the cash level. So there were many prominent analysts—in fact, one of the largest brokerage firms on Wall Street suggested that oil would trade at \$20 a barrel and remain there for an extended period of time and our belief was that that was unlikely to occur because these companies are not irrational, nor do they have financially strong balance sheets to withstand those kind of losses (1:07:34)

Okay, so let's look at what the industry's actually done and how they've responded to the lower oil prices. In every region, every major oil region around the world you've seen substantial exploration and production, capital expenditure cutbacks. Even in the low cost OPEC nations. In fact, it's very rare that you'll see two consecutive years of negative capital expenditure cuts. If 2016 plays out like it looks like it will, it will be second year in a row, it'll be the largest drawdown in capex budgets since the numbers have been tallied and that's both in absolute dollars as well as percentage. (1:08:34)

Okay. So the US has been one of the largest incremental suppliers of oil over the last five years, about five million barrels. Steve alluded to it earlier in his conversation, in his discussion. We've had about five million barrels of oil from 2010 to 2015 that came onto the market, and you had a

lot of drilling activity that was associated with the oil coming to the market. However, the US has responded very rapidly. You can see at the peak, over 1500 rigs were working. Today—this chart has not been updated—but as of Friday the numbers just came out—you have 325 rigs that are working in the fields as of last week. (1:09:34) On the right hand side here, more importantly, you can see the well completions, so when you drill a shale well, you actually drill down—and let's just say for argument purposes you're going to drill down 10,000 feet, roughly two miles. Then you're going to turn the drill bit and you're going to drill another 5,000 feet or about another mile. That's called horizontal drilling. In that horizontal part of the well you actually have to frack that well. That's called the completion part in the process. And you can see back in 2014 we completed nearly 30,000 wells. Today we're down two-thirds of that. And these wells have very high decline rates and if you're not drilling and completing wells, your production's going to fall. (1:10:25)

Okay, so this is what's happened here as the drilling activity has slowed. We peaked out in the middle of...call it the first half of 2015 at 9.6 million barrels. As of...the kind of the year to date numbers, 2016 production's down 500,000 barrels thus far this year. Since the peak we're down 875,000 barrels. Eight hundred and seventy five thousand

barrels, so almost a million barrels in the last...call it, year. To put that in perspective, Iran's production, which is rapidly grown since the economic sanctions have been lifted, their production is up only 700,000 barrels, so what they put on to the market has been more than offset by the US decline. (1:11:23)

Okay, another busy slide and I apologize in advance of this, so you got blue lines, you got gray shaded stuff, you got black stuff; but the line that I really want you to focus on is this right here—this is called spare capacity. So the definition of spare capacity is oil that can be brought onto the market within the next 90 days without having to drill nor complete a well. So in other words, the well's already been drilled, the well's been completed, the well is operating; just the pressure valves have been turned down. And so within a very short period of time you turn the valves to the right and you'll get more oil. Why is this important? If you're a refinery, you're main input, your really only input is oil. You need oil to refine to crack into process into gasoline, diesel, kerosene, just a lot of different petrochemical products. (1:12:28) When the spare capacity is really high, you're not so worried about supply. There's an abundance of supply, therefore I don't need to like rush into the market and demand a lot of oil because I know it's there. So you can see it's come down and

prices kind of go up and down. What I want you to focus on is right here. At this five percent level what happened was fairly interesting, because when the spare capacity got down here, that was a temporary phenomenon because what happened was Iraq invaded Kuwait and the Kuwaiti oil came off the market and then Saudi Arabia took all the spare capacity and eventually basically put it on the market to offset the Kuwaiti lost oil but then the war ended and Kuwait oil came back on the market so spare capacity went back up as the Saudis backed off. But here around the 2001, 2002 period, spare capacity dropped below five percent. And it stayed there or an extended period of time, almost a decade. (1:13:29) and oil prices shot up, they actually went up more than fourfold. And it makes sense. If there's not a lot of spare capacity, refineries are very nervous. They need that product to sell their product into the marketplace.

This spare capacity issue is a real kind of controversial issue. There's not a lot of great data on it. The best analyst that we've found is a guy named Michael Rothman, who's been in the business for 30 years, headed Merrill Lynch's energy department for a couple decades and now has his own firm. He's been attending OPEC meetings for the last 30 years. And the conventional wisdom is that there's about two million

barrels today of spare capacity, largely in OPEC nations and largely in Saudi Arabia. (1:14:30) Michael Rothman suggests it's a million barrels or less, and that's really important. And I'm just going to use a quick analogy here—so if people think Saudi Arabia can throw another million or two million barrels of oil onto the market real quickly, and they have a theoretical level of production of 12 and a half million barrels a day. They're producing about 10 and a half million barrels, but there's your two million spare capacity. But I play golf. I'm not a good golfer. But on my golf course there's a par 72. There are 18 holes, and every hole, let's just say is a par 4. In other words, I hit the ball in the cup within the four strokes per hole. So that's a par 72. If I get a birdie, that means I get one less than what was required, in other words, I get a three. (1:15:29) I birdied every single hole on my golf course. So theoretically I should shoot 54. I've never shot less than 80. And that's an issue with the Saudis. The Saudis theoretically can produce 12 and a half million barrels a day, but these wells are so complex and there's so many of them, some are on shore, some are offshore, and there's a tremendous amount of issues going on, that theoretically they can do 12 and a half million just like theoretically I should be able to shoot 54 and I don't even get close.

Okay, so what happened? Oil prices cratered. We missed it. This is what happened. (1:16:21) As the US production of shale oil came onto the market—and it came on very strong—and the productivity actually, of the US wells was much higher, much greater than people expected—we peaked out in the first part of 2015. In the latter part of 2014, Saudi Arabia got word that the Western countries were negotiating a nuclear deal with Iran and Iran is their largest adversary in the region. And they put out an additional—actually, this is not exactly accurate because for a temporary period in the third quarter, their production would hit 10.6—these are just ending quarter production numbers. The number actually got to 10.6. The Saudis, in a very short period of time put a million barrels of oil into the market. (1:17:30) They took, in effect, about half of their spare capacity and dumped it into the market right as the US was peaking and there's just a flood of oil. There's about a million and a half barrels of excess supply in oil at that point in time. The Saudis said, "Oh, we just want to maintain market share." But the growth was over eight percent. Yet demand was growing only two percent or so. The Saudis know that oil demand wasn't going to grow eight percent. In fact it's been decades since we got even close to eight percent. They used the price as a weapon and that's what we missed.

Okay. The Saudis felt they could do this because they had stockpiled seven and a half billion dollars of foreign reserves and they felt they can outlast the Iranians. (1:18:28) Unfortunately it doesn't really appear the Iranians have changed their behavior, and the Saudis' foreign reserves will likely fall about \$200 billion dollars by the end of this year. They're having to cut their budgets. They're now in deficit, they're talking about selling part of Aramco, they're issuing bonds and if oil prices were to stay around the \$40 level, they would have only three and a half years left of reserves. It's not likely playing out exactly how they intended.

Okay. Let's turn to demand. We've talked about supply. We think supply is coming down. (1:19:26) We can see non-OPEC supply—US is down, non-OPEC, non-US is down pretty substantially. In fact, non-OPEC, non-US oil production was in decline when oil prices were over \$100 a barrel. So let's turn to demand. As Sir Martin was talking about, the global economies around the world are really not growing that much. In the US we might be growing one to two percent. Europe was in recession last year. Japan was in recession last year. As he alluded to, China's decelerated substantially. This is a demand forecast. The pink right here is the initial forecast from the IEA. (1:20:18) This burgundy color is the actual number that was demanded in the marketplace that year,

and what's interesting about this is that the IEA's estimates—and most analysts use the IEA as their reference to build their model in terms of future demand—turns out the IEA is generally about a half a million to a million barrels shy of what the actual demand ends up being. And for 2016 the IEA initial demand forecast was for 1.2 million. They recently revised it to 1.3 million. Okay

It's true that there was a commodity bubble. The commodity bubble burst, China's decelerated. I have no reason to disbelieve Sir Martin's view that China's growing only two or three percent. It makes sense to me, looking at these numbers. I wouldn't want to be in the cement business, I think. Coal, steel, iron ore—very tough business. Very tough. (1:21:27) What's fascinating is that according to Goldman Sachs, gasoline demand is growing at double digits and kerosene is also growing double digits. Now, kerosene is just a proxy for aviation fuel. And if you think about it, what's happening in China is the east coast has largely been built out, developed, and they're not pushing to the interior of the country and it's a large country. As they push into the interior, yes, growth has decelerated but miles driven, miles flown increase. So this makes sense.

Okay, two more slides and we're done. This is again a little bit complicated but I can walk you through it. This comes from the Band Credit Analysts, or BCA. (1:22:19) And prior to today or maybe the last couple days, we were thinking about the presentation...what I'm about to say I think would have been somewhat controversial because the consensus believes that the market is still oversupplied by a million and a half barrels a day. A couple data points. Number one, in the month of April, the consensus opinion was that global storage of oil would increase by 45 million barrels for the month. One point five times 30 is 45 million barrels, that's how they got the number. The month of April, the storage numbers actually declined by 16 million. (1:23:16) This morning the main numbers came out, the preliminary numbers came out and that's why oil prices went up this morning and likely why oil prices have gone up 80 percent over the last couple months; in the month of May, the analysts again were expecting a 45 million barrel build and the numbers came down 30 million. So what's happening, according to BCA and other analysts who are now catching on to this is that you could see the total supply is coming down but demand continues to grow, we're growing at about 1.2, maybe 1.3, possibly 1.5 million barrels a day. And supply has

come down so fast right here that we're now digging into the very large storage numbers that we have around the world.

So what does this mean? According to BCA, if you work the math out, by the end of the year we'll have drawn down about 180 million barrels of inventory.(1:24:21) The issue we had with BCA analysis is they are assuming that demand is 1.2 million barrels growth—IEA just upped it to 1.3. If we increase it by 100,000 incremental demand, interestingly they believe—so the US is this light blue—they believe the US supply will only go down about a half a million barrels a day. Well, for the first five months of the year we're already down a half a million barrels. Actually, if you work the trend rate, we'll be down over a million two for the year. When you factor all those numbers in, we potentially will draw down 400 million barrels out of inventory and this is what this slide is. This is actually cornerstone, again, Michael Rothman—his numbers are actually a little larger than ours. He believes we're going to draw down, we're now starting to draw down...you can see here's the second quarter and we're kind of like at this first little data point right up here, and as we fall down and keep on falling by the end of this year we're going to draw down 450 million barrels of oil if these trends continue. (1:25:36)

What's fascinating—if Michael Rothman is correct—and we have a couple data points and also last week there was an OPEC meeting in Vienna. They have a biannual meeting. They have it in June and then they meet generally in November, and the new oil minister for Saudi Arabia was interviewed on Bloomberg and I encourage you all to get this interview—because he said two fascinating things: number one, the market is now undersupplied. I've never heard that before in the last year and a half. And he also said that inventories would come into balance very quickly. (1:26:19) And this is, I think, what he's referring to—Saudi Aramco has great analysts and they get all the consultant numbers, they get everything that Michael Rothman can get and—if we fall down to this level we'll actually be below where we were in Q1 2014 when oil prices were \$100 WTI 115 on Brent.

Now obviously that's so far from consensus, but the data is the data, right? We're just showing you the data and in two months you can't really draw a line with two data points. But if these numbers continue to drop, we think oil prices will eventually converge back toward our long term price which is \$80, \$85, which is the marginal cost of production. With that, I'll conclude my remarks and we'll open up for Q and A. Thank you. (1:27:24) Questions? Yes?

Q1: Would you consider increasing your energy portfolio given your data?

Dennis: So our weighing right now is around 25 percent and it's up and it has increased, it has gone up. We think it's prudent to be around that level. Look, I mean we took some big hits, right? The supply and demand fundamentals were in good shape back in 2014. We missed the Saudis playing a geopolitical game where they just dumped half of their spare capacity onto the marketplace. They have another million barrels or so, maybe half a million barrels or so. (1:28:28) They could do that. In fact, they might do that really soon because—I'm not sure if you know—but on Friday in Nigeria one of the large oil terminals was blown up. That's 250,000 barrels a day and there's also problems in Libya. So within OPEC there's disruptions that are going and no one really knows how long those disruptions are going to occur. If they get back online, they fix the pipeline, if they can fix the terminal, the Saudis still have that half a million, 80 million barrels they could put out to the marketplace. So we feel pretty good about the weighting right now.

Arik: I'll step back and I—it's not about energy or any specific industry. The way we go about it is we think about the upside case scenario, we think about our downside case scenario and then you look at that ratio. And based on that, we know what weighting we want to have for any given

name. (1:29:36) So clearly we don't know when oil prices are going to go up, but we believe, our thesis is oil price is going to go up so all we care about right now is having the right companies with the best assets and companies with the right balance sheets that are going to survive this downtrend, and based on that we are weighting those names. And if you look in our portfolio in the Capital Fund, we can have at most a five percent weighting on a name at the time of purchase. It can become a 10 percent name if the stock does really well, but when we purchase it can be a five percent name.

So if you look at March 31 numbers, we have more five percent names in the portfolio today than we've had since I joined FPA. It just tells you that we've taken the names, we have taken more names to our absolute most because our conviction is very high. If you were to find two other names in the same industry that we believe gives us the same risk to reward ratio, that number can go up, but this is not about energy, it's about every name and every industry. We don't say that based on the information we have energy should be an x-percent weighting. It's just we look at company by company and the total industry weight just falls wherever it falls.

Dennis: And I think Steven said it well this morning. The industry's not chock full of great companies. There are only a few really good companies that have generated a good return on their invested capital, particularly on the E&P side. The vast majority of these companies have destroyed capital.

You look at a company like Cimarex, which is one of our largest weightings on the E&P side. It's a great company, among, if not the lowest cost producer. They have got amazing Permian basin builds in the Delaware basin, Permian basin split into the western part of Delaware, the eastern side is the midland basin. Great company. There aren't many Cimerexes out there. (1:31:25)

And so yeah we could stretch, but that's really kind of moving away from what we've done in the long term and that's really by...good companies with good returns on capital. Other questions, yes? Back over here?

Q2: Thanks for the time. Just really quickly, I'm wondering if you can comment through the last six quarters how the makeup of industries within the energy sector has changed in terms of your exposure in the Fund, and then also really quickly in terms of the quality of management on the for-profit education side; what you've learned and maybe how you can apply that to other companies that you've looked at.

Dennis: Okay, good question. So I'll answer the first part and you want to take the second part?

Arik: Sure.

Dennis: So what we've done is we've tilted the portfolio. It was already tilted toward largely US land. We started doing that in the first quarter of 2015. (1:32:25) We swapped out of—when it was really clear to us we swapped out of Ensco, which is an offshore drilling company, great company, probably one of the best management teams out there but we didn't really want their kind of exposure to the offshore which we think it's going to lag behind the onshore.

We think there's shovel-ready projects in the US. Oil prices just need to rise and it's what they call short cycled, so we want to tilt the portfolio toward more US land based and so we swapped out of Ensco and into Helmerich and Payne, which we owned in the past, we call them old friend. We bought that one in 2011 when it was in the low, mid 30s.

Then in 2014 we sold it, stock was over 100 or so. Stock came cratering down into the low to mid 50s, we swapped out at Ensco into Helmerich and Payne and then later on in the year we sold out Atwood—another offshore drilling rig company. (1:33:26) Again, great company, hitting record profitability but again some of their contracts are ending.

Stock was in the \$20, \$30 range and we felt that at the time Patterson, which is another company we had owned in the past, another land based company. That stock fell into the low teens and so we swapped out of Rowan and into Patterson.

So I would say 90-something percent of the energy exposure is tilted toward US land because of the shovel ready projects. Oil prices need to migrate back toward the marginal cost production and the service companies will go back to work and these E&P companies that we have should be able to generate substantially more cash flow.

Arik: For profit side as I mentioned earlier, we're looking for companies that are market leading companies. So Apollo, which owns University of Phoenix, that's the number one online education company in the United States. DeVry is another close second so they are obviously the market leading companies. DeVry has other businesses. DeVry is a market leading company in that they provide the most amount of residents to US medical residency programs. They have 15 nursing schools, they're a market leader. We had a history of profitability; neither of these companies have ever lost money, with strong balance sheets, both of these companies had tremendous balance sheet strength, zero debt, extreme high levels of cash. And the fourth number, the fourth item is good management teams.

So clearly at the time of investment we thought that both Apollo and DeVry had good management teams.

But it turns out that you don't really understand how good a management team is until they had a moment of crisis and especially the moment of crisis is a moment that lasts years. And everyone has a tipping point and these management teams and their boards hit a tipping point. (1:35:27) And what happened is Apollo decided to agree to be acquired by Apollo the private equity firm at a price—and we had been very public about it— which we deemed to be below the value that the shareholders deserved. So that's really a bad management team and bad board making a bad decision.

And DeVry, despite their stock price not doing well, we thought that the cult of education continued to improve. Their non-US basic education business has been actually very strong, which makes up about 80 percent of their profits. So we were very happy with the management team there. But then the board with the continued decline in the stock price, decided to make a change and they replaced the CEO.

So stepping back these are changes and when your average holding period is seven years you have to feel comfortable that things aren't going to change and when things are going to change you hope

that they're going to change for the better or you're going to own more of it maybe at higher prices because now you like the upside, downside ratio better, but the flip side can occur, too.(1:36:29) And in these two instances, the flip side occurred so we sold some stock in both companies.

The big learning is in the past we have made decent returns on companies that have A&B shareholder structures. And Apollo had an A&B shareholder structure and this is one that we have been very unsuccessful when we try to manage with the management team and the board. So the amount of upside we require for a company that has A&B structure is going to be greater than when we first entered this situation. So that's been a really good learning for us.

Dennis: But just to be clear, we didn't buy Apollo when it was sky high. We'll probably take a 20 percent hit or so because of this lowball takeover. We bought the stock when it was trading at two times Enterprise Value to EBITDA and it's being sold for one and a half times Enterprise Value to EBITDA—and by the way, the company's generating free cash flow. So unfortunately a lot of the class A shareholders went along with the class B shareholders.

Arik: We can take one more question.

[PAUSE]

Dennis:       Okay, no more questions? Great. We'll head off to lunch. Thank you all  
                  for attending. We'll see you this afternoon.

Arik:           Thank you.

[APPLAUSE]

[END FILE AT 1:37:52]