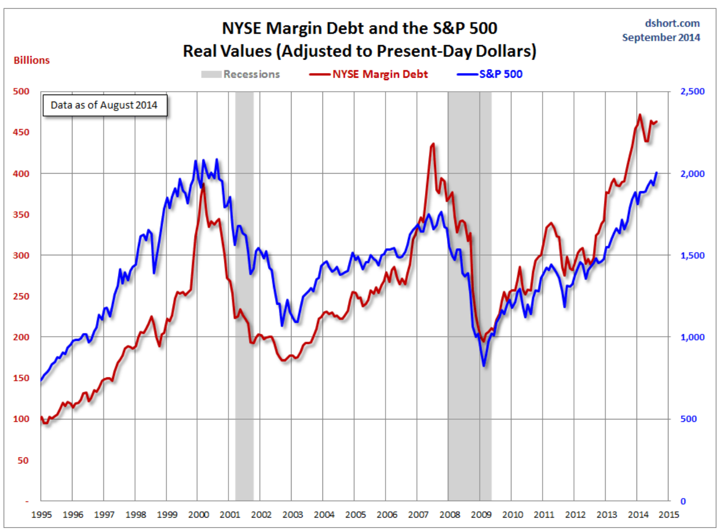
October 16, 2014

Global equity markets have dropped 10% in recent weeks, erasing gains for the year. Our large cash reserve has provided a cushion from the brunt of the recent fall. While performance has declined a bit further this month, our losses have been a fraction of those suffered by equity indices, which have shed five to ten percent in October alone.

Given increasing volatility and corresponding investor skittishness, we thought it might be helpful to put recent market action into perspective, while reinforcing our investment discipline at Broyhill. There are just three key points we would like to make in this letter. If you have questions on any of them as it relates to your portfolio or our process, please don't hesitate to pick up the phone. We'd be happy to go into as much (or as little) detail as you'd like.

1) **Following last year's massive rally in stocks, which on some measures exhibited the lowest volatility in decades, investors should be prepared for increased levels of volatility moving forward.** Markets have a tendency to extrapolate periods of low volatility into the future. Reality is rarely this tranquil. Stable environments sow the seeds of their own demise as speculators respond to rising prices with greater leverage to magnify lower returns. Some folks will just never learn. Magnified leverage ultimately results in magnified volatility.



2) **It is important to emphasize that increased volatility does not necessarily translate into increased risk.** The only risk investors should concern themselves with is the risk of losing money[1].

[1] *In a 2006 memo, Howard Marks explained why volatility is the prevailing measuring of risk, but also why it falls far short as "the" definition of investment risk. Perhaps Einstein said it best in that, "Not everything that can be counted counts, and not everything that counts can be counted." Back to Howard's memo: "In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don't think most investors fear volatility. In fact, I've never heard anyone say, "The prospective return isn't high enough to warrant bearing all that volatility." What they fear is the possibility of permanent loss.* ***Permanent loss is very different from volatility or fluctuation.*** *A downward fluctuation – which by definition is temporary – doesn't present a big problem if the investor is able to hold on and come out the other side. A permanent loss – from which there won't be a rebound – can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when the investor sells during a downswing – whether because of a loss of conviction; requirements stemming from his timeframe; financial exigency; or emotional pressures, or (b) the investment itself is unable to recover for fundamental reasons. We can ride out volatility, but we never get a chance to undo a permanent loss."*

The riskiest thing in the world is consensus belief that there is no risk, which seduces many to chase returns. Chasing returns drives prices higher (and future returns lower) making assets more expensive and hence, more risky. Paying too high a price is the simplest way to increase risk of loss. Luckily, it is the easiest risk to avoid.

The best way to reduce risk is to buy at a lower price, which provides the astute investor with a margin of safety. As asset prices decline, the herd may view them as riskier. Truth is, assets become less risky at lower prices. As a result, increasing volatility, coupled with growing fear that the market is risky, can actually make it quite safe.

3) **Increased volatility does, however, provide us with increased opportunity.** As we said in our Annual Letter, "The greatest buying opportunities arise when liquidity is in short supply and anxious investors, consumed by fear, are forced to sell securities as prices fall. Leaving the party early will almost always result in short term underperformance during the later stages of bull markets, but it is the only way to ensure that you have the resolve, the discipline, and the dry powder to buy when risk is lowest and expected returns highest."

We left the party early last year while many of our peers decided to stick around for last call. Experience has taught us that nothing good happens that late in the evening. Investors would be better served to head home early for a head start on building an inventory of ideas for tomorrow's opportunity set. There is just no reason to settle for lower quality opportunities before last call, when Mr. Market is sure to serve up much more attractive dishes tomorrow. One of our greatest advantages at Broyhill is the flexibility we are afforded to commit as little or as much capital as we determine based upon an independent appraisal of valuations and expected returns.

Subdued volatility created a scarcity of opportunities that met our return requirements over the past year. That has begun to change. While broad markets remain expensive and near all-time highs, we have recently uncovered a number of individual opportunities trading at attractive valuations after suffering much steeper declines.

Recognizing that I promised "just three points" at the outset of this letter, this concludes our regularly scheduled programming for the quarter. For more color on the growing opportunity set, feel free to flip ahead to the brief appendix, which encapsulates our recent communications with a good friend and current investor.

Sincerely,

Christopher R. Pavese, CFA

P.S. Please be sure to congratulate Nancy on her freshly minted marriage next time you speak with her. She tends to keep these things to herself so we do our best to embarrass her as best we can here in Broyhill Land!!

The Growing Opportunity Set

Given the amount of cash we have on hand today, our investors should be hoping for the market to fall, as panicked sellers give us the opportunity to invest at lower prices, which ultimately drive future returns. We recognize that this is counterintuitive and may mean short-term losses in those positions we currently hold, but those losses should be less than those suffered by the overall market, and more than offset by gains from additional purchases. The examples below should give you a sense of the opportunities we see today, as a result of recent volatility:

- The collapse in energy prices has wreaked havoc on the oil sector, which has dropped 20% since the summer. Many stocks in the industry have fallen much further. A recent investment in a Norwegian drilling company has effectively been cut in half in recent months due to uncertainty around Scottish Independence and the speculative unwind in commodity-related businesses. In the short-term, we are likely to see continued volatility in the shares. In exchange for accepting this volatility, we receive the majority of the company's cash flow in the form of dividends, which approximate a 30% yield today. The founder owns about half of the shares outstanding and the company's rigs were last valued in excess of the total market capitalization.

- Investor appetite for Latin American has gone from red-hot to ice-cold as many economies in the region face a combination of structural and cyclical macroeconomic pressures. As a result, volatility in the region has provided us with an opportunity to purchase a number of high quality assets. The largest McDonald's franchisee in the world, headquartered in Buenos Aires, is a fitting example of the current opportunity set. The company's founder has managed the region for McDonald's for decades and is the largest shareholder of the stock, which has fallen from a high near $30 to recent lows below $6. Our margin of safety comes in the form of real estate assets, which were recently appraised at a value not far from the current stock price. The business generates the majority of its earnings in Brazil but Argentina operations have also weighed on recent results. Given the pending catalysts on the horizon in the form of shifting political regimes, we've also begun accumulating shares in an Argentine real estate company currently trading below $13 with estimated net asset value in the vicinity of $30 or better. We discussed our views on the region with the WSJ in a recent article.

- At the risk of missing Lucca before bedtime tonight, I'll wrap up with a few more ideas worth consideration. Oaktree has lost a quarter of its value in recent months as the company's assets under management have reached all-time highs. At the current valuation, we think investors are paying a fair price for the firm's management fee-related earnings with significant upside in incentive fees, considering the $10 billion just raised for new distressed opportunities. Time Warner is now trading 20% below the price Fox offered to purchase the entire company. A market multiple on long-term earnings forecasts (which may prove conservative given the untapped potential at HBO), would put the stock at $120. Last but not least, increased volatility combined with noneconomic selling of recent spin-offs, has provided investors with an opportunity to buy a high-quality, high-margin, industry leader 30% below the price offered by Mr. Market two weeks ago.

Short term declines in recent purchases have been greater than "normal" of late, but this is not unusual in the sense that we aim to buy when stocks are falling. And since it's impossible to know precisely where the bottom is (but we'd appreciate a call if you do), cheap stocks can get cheaper after our initial purchase. Often times, we expect and hope to buy more at lower prices and this is why we still hold plenty of dry powder in portfolios.

We don't avoid risk. Avoiding risk also means avoiding returns. Instead, we are happy to accept risk when we are being compensated for taking it. Or as Will Rogers said, "You've got to go out on a limb sometimes because that's where the fruit is." We find it easier to go out on a limb when the consensus is falling from trees, and when we have a thorough understanding of what the fruit is worth.

Broyhill Asset Management, LLC

Broyhill Asset Management is a private investment management boutique. We believe that capital preservation coupled with consistent, compounded returns is the key to long term wealth generation. We are conservative investors for our partners and for ourselves. Our objective is quite simple - superior risk-adjusted performance.

Since the sale of Broyhill Furniture in 1980, the Broyhill family wealth has been managed as a single family office. Today, we are privileged to be able to offer the same level of expertise developed and refined over a quarter century within the Broyhill Family Office, to additional families and investors. We have the highest respect for the trust our investment partners have awarded us, and pledge to always treat non-family investments as if they were our own.

Our Services

The philosophies and strategies we endorse for our investors are only those we have developed and deployed for ourselves. We currently offer investors three different investment strategies, each of which is fundamentally driven by the same objective – income generation and capital preservation. Each is consistent with our own goals and leverages our expertise in asset allocation, in equity research and in credit analysis.

The Broyhill Portfolio is a diversified, multi-asset class investment strategy. Macroeconomic fundamentals and long term investment themes drive the portfolio construction process which is routed in a strict valuation discipline. Embedded in our approach is a relentless focus on the preservation of capital and the belief that risk management begins with portfolio construction. The objective is simply maximum total return, commensurate with the given risk profile of global capital markets and best suited for investors with a long term time horizon.

The Broyhill Opportunistic Fixed Income Portfolio is a separately-managed individual bond portfolio focused on short duration, high-yielding fixed income securities. The portfolio aims to combine a high probability of the safe return of principal with a current return superior to a portfolio of US Treasury securities. A rigorous research process drives the selection of only those securities that meet our requirements based upon an independent assessment of each issuer's fundamental strength. The result is a cash-generating portfolio focused only on our highest conviction ideas.

The Broyhill High Quality Dividend Portfolio is a concentrated equity strategy invested in a select group of exceptional businesses judged to be competitively entrenched market leaders, trading at reasonable prices. Our research seeks to identify outstanding companies with sustainable competitive advantages, rather than speculate on mediocre businesses with uncertain futures. The result is a portfolio of profitable businesses which offer the potential for full participation in up markets while mitigating the brunt of down markets, delivered to investors in the form of attractive dividends and consistent earnings growth.

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