July 6th, 2018

Dear Friends and Investors,

For the quarter ending June 29th, 2018, the core portfolio returned 8.7% net of all fees and expenses compared to 0.3% for the MSCI All Cap World Index. A composite of all accounts managed by Massif Capital, was up 6.6%. Year to data the core account has returned 0.8% net of fees compared to the MSCI All Cap Work Index which has returned -0.25%. Since inception in June 2016 through the end of the second quarter 2018, the core portfolio has returned 23.1% net of all fees and expenses compared to 31.5% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on initial investment date.

Portfolio Review

After a difficult first quarter, the portfolio has regained significant ground during the second quarter. Positive results were driven by nearly every position in the portfolio, with the exception of Barnes & Noble Education (BNED). Leading the portfolio were our duo of offshore oil field service companies, Diamond Offshore (DO) and Teekay Offshore (TOO), and mid-tier copper/gold miner Nevsun Resources. Together these three stocks boosted the portfolio 9.7% gross of fees.

Offshore Oil Companies: Diamond Offshore (DO) and Teekay Offshore (TOO)

Contract driller Diamond Offshore and shuttle tanker operator Teekay Offshore, represent approximately 23% of the portfolio. The performance of DO has been strong, but in many ways disappointing as it has traded closely with oil, a demonstration in our mind of the markets inability to recognize both a management team that has maintained a rock-solid balance sheet in a sub-sector of the oil industry largely devoid of them, and a firm actively pursuing ways to provide clients with a differentiated and superior service. Our DO position is up 32% but there is still significant runway before this company is correctly priced.

In a somewhat similar fashion, TOO remains a company with a bright future. Brookfield Business Partners, owner of 60% of the company, continues to push the balance sheet revamp forward while multiple cash generating growth projects come online. The long-term fixed price contracts, combined with the ongoing deleveraging, mean the portfolio is likely to benefit from capital appreciation and capital return in the medium to long term. The firm has been largely range bound since 2017, despite the fact that the management team, ownership and balance sheet of the present company is vastly improved and indistinguishable to the 2016 firm.

While our thesis is not predicated on the price appreciation of crude, we do believe that both companies will continue to benefit from the tightening global oil supply. We remain bullish on oil and the June OPEC meeting has only strengthened our conviction. The lack of cooperation between cartel members to ease a tight market is unsurprising; it is after all a group of countries with no common interests outside of the price of oil, in our minds a poor foundation upon which to build a strong alliance. Brent crude has appreciated 16% over the last quarter and looks ready to appreciate further on supply constraints. The re-imposition of US sanctions (slated for November 2018) on Iran following the US administrations withdrawal from the nuclear deal, combined with renewed fighting in Libya and continued deterioration in Venezuela may remove an additional million to two million b/d of production by the end of 2018.

We recognize that Saudi Arabia has the bandwidth to release an additional two million b/d to ease constraints, a position President Trump is frantically calling for and an easy counterargument to continued price appreciation. If the Kingdom obliged, this would nearly eliminate global spare capacity and likely deliver further bullish price action with the market rightfully concerned about producers' ability to respond to future supply disruptions. That being said, a ramp up of that level would take well in excess of six months, significantly blunting its impact and doing little to ease the existing market constraints.

Mining Investments

Our first mining investment, Nevsun Resources (NSU), started to show some life this quarter following a buyout offer led by Lundin Mining. The offer valued the company at $5.00 Canadian or roughly 27% above our average purchase price. Management rejected the offer for a combination of reasons, which we believe were reasonable, including a belief that it undervalued both the companies operating mine and its Timok copper-gold project in Serbia. Having been to Serbia to see the project, and spent significant time with management discussing the project, we believe they were correct to reject the offer. The wait for Nevsun to achieve full valuation may be long but we believe it will be well worth it, a sentiment echoed recently by Rio Tinto who has stated they are in the market for world class shovel ready copper projects, of which there are only a handful globally (Timok being one of them) and they were prepared to pay a significant premium.

A bidding war is not out of the question, but we do not feel it is likely. A buyout might be the quickest remunerative exit for Nevsun but it might not be the best outcome. Management is experienced and an operating mine could generate a greater return in the fullness of time.

Our other mining investment, Lucara Diamonds, has languished for much of the quarter down between 7% and 15%. Our conviction remains high and we have lowered our average entry price. The balance sheet is pristine (no debt and roughly $50 million in cash), the assets are almost all new, the management team is as well respected as any mining team in the business and the company is currently trading at a free cash flow yield of 19%. Following two years of drilling, the firm recently released an updated resource estimate that increased the indicated mineral resource from 4.42 million carats to 6.78 million carats of diamonds.

We believe many market participants are wary given the recent moves by DeBeers into lab grown diamonds. DeBeers is marketing their new initiative as a fun, cheap way to upgrade your everyday accessories, not a substitute for real diamonds. DeBeers planned capital investment of nearly $2 billion in diamond mining operations over the next few years is supportive of the idea that even insiders don't think that lab grown diamonds will replace natural diamonds for consumers looking to make a statement purchase anytime soon.

New Positions during the 2nd Quarter

In early June we added a short position in Norwegian Cruise Line Holdings (NCLH) to the portfolio. A full investment report is available on our website. Our thesis revolves around a forthcoming supply/demand imbalance which, coupled with compressing margins and the firm's inability to translate revenue into returns, suggest a valuation half of where it trades today.

Cruise stocks traded down sharply in late June, largely due to the revised guidance on operating costs. We agree that rising fuel costs are problematic, but the larger issue remains global demand keeping pace with supply. The industries tone regarding Chinese growth potential (necessary to fulfill unprecedented ships on order) has been inconsistent. Adjectives such as "significant" and "large" dominated managements discussion of the Chinese market as recently as last year. The tone in Q1 2018 has changed considerably, with management teams now describing the market as "teeny tiny" and "embryonic". We remain confident in our thesis and believe that we will see milestones supportive of a weakening demand profile in the latter half of 2018.

During the second quarter we also added a long position in GrafTech (EAF). EAF is one of only a handful of global producers of ultra-high-power graphite electrodes for use by electric arc furnace steel producers, a critical component of the steel manufacturing process that currently has no substitute. The business benefits from being the only market participant that is vertically integrated and thus capable of selling its products on long term take or pay contracts. We are looking to grow the position at favorable prices and are optimistic that the portfolio will benefit from not only capital appreciation but also significant capital return in the form of dividends and share buy backs. A research report on GrafTech will be published shortly. In the meantime, interested investors can watch a presentation we gave as part of MOI Global's Wide Moat Investing Conference in June of this year.

The Remainder of the Portfolio

The balance of the portfolio was quiet on news this quarter with most positions trading rangebound and sideways. Steel Partners, a long time holding, made an offer to buy the outstanding shares of Babcock and Wilcox Enterprises. This offer was expected but there has been no news on how the offer has evolved. Barnes and Nobles Education reported their best fiscal year results in two years. Management continues to hit singles and doubles, moving the business forward in the right direction. The market at first appeared to appreciate the results, sending the stock up more than 7% the day results were announced before reversing course and taking the stock down more than 30% from its post results peak over the course of six days. While the price action of the stock remains volatile, we have taken advantage of the recent sell-off and have lowered our average cost.

Despite our often-bearish tone, we are optimistic about the position we find ourselves in today. The market may be richly priced with unprecedented valuations, but much of the energy sector, mining sector and industrials are trading at historically cheap valuations relative to the rest of the market. Long term, we see tremendous opportunity in these spaces. There remains a significant misallocation of investor capital away from "old-economy" industries and believe it is worth reminding our investors and everyone else of the following:

> *Investors forget that the modern tech industry is nothing more than a derivative of the raw materials industry, a set of increasingly sophisticated ways of transforming, arranging, and combing the same silver and copper inputs that we have been combining in different ways for hundreds of years. Without the billion-dollar industries [energy, mining, industrial, etc], the trillion-dollar industry [the technology industry] is worth nothing.*[1]

[1] Global Mining Observer, May 2018

Inflation Has Arrived

We return to inflation, an important theme we have written on in the past, most recently in a white paper, *Nowhere to Hide*. The year-over-year Consumer Price Index (CPI) sits at 2.8%, a level not seen since 2012 and almost 75 basis points higher than when we published our last commentary. This does not come as a surprise. Large increases in the quantity of money, at rates that exceed nominal GDP growth, create the risk of significant increases in prices. Following several years of significant asset price inflation, we believe we are just beginning to see the widespread signs of price increases in the consumer economy. Changes in demographics further support our thesis of continued inflationary pressure.

A recent study by the Bank of International Settlements (BIS) examined the *enduring link between demography and inflation*. This is particularly interesting as the labor force participation rate in the United States has been falling steadily since 2000 and the largest generation in history is pushing past the age of retirement. The BIS report finds that inflationary pressures rise when the share of dependents in an economy increases, a relationship that has held steady since 1870.[2] Apart from the academic, econometric driven conclusion, this logic seems to hold some weight. As individuals leave the labor force, unemployment drops, all else being equal. With a tighter labor market, companies must increase wages to hire and remain competitive. If firms wish to maintain margins in this type of environment they must raise prices.

Aggregate financial data may not yet be showing widespread inflation but management commentary during recent earnings calls tells a different story and lends credence to the BIS report. Stein Mart (SMRT), Hibbett Sports (HIBB), Foot Locker (FL), Kohls (KSS), DSW (DSW) and Lumber Liquidators (LL) all have noted increases in their average sale price. McDonalds (MCD) and Vitamin Shop (VSI) both highlighted the impact of higher commodity costs and higher wage rates on finances. Natural rubber has seen a notable increase in price, raising the cost of tires. In conjunction with a transportation labor shortage and higher fuel prices, B&G Foods (BGS), General Mills (GIS) and Tyson Foods (TSN) have all indicated they will pass along increased freight costs to consumers.

The Wall Street Journal ran an expose in June on a Colorado plumbing company that has faced such a dire labor shortage that they are throwing the kitchen sink at employees: arcade games, meditation rooms, on-site spa treatments and jet-ski outings. U.S. job openings hit a record 6.6 million in March with the construction industry experiencing one of the largest jumps. Incentivizing retention and attracting new employees comes at a cost that is most likely absorbed by the consumer.

The CPI Index is a lagging indicator. It should come as no surprise that we are not confident that 2.8% reflects the true price increase rolling through the real economy. A recent study on social security benefits observed that while cost of living adjustments have risen 46% since 2000, benchmarked against

[2] Literature supporting this idea note that as the share of dependents (the young and the old) increases, the savings rate decreases, driving up the natural interest rate, i.e. the real equilibrium interest rate. The natural interest rate is a hypothetical construct and cannot be observed. Typically defined as the rate at which the real GDP is growing at its trend rate, and inflation is stable. It is a benchmark for policymakers to compare with the market rate. Such changes in the natural rate (an increase driven by a lowering of the savings rate) can lead to trends in inflation if monetary policy becomes constrained, or more broadly, does not fully internalize them.

the CPI Index, the expenses of a typical retiree grew by 96.3% over the same period. Of the 39 costs analyzed in the report, 26 grew at a faster rate than CPI.

As investors who care about companies and the real economies they operate in, it is prudent for us to consider the impact of inflation on a firms cost structure and pricing model. Examined through the lens of demographics and coming on the tail end of the largest expansion of the global monetary base in history, there will likely need to be several hard catalysts to reverse the underlying inflationary trends prevalent throughout the economy. We remain optimistic about the broader commodity landscape and investing in real assets that deliver real value in such environments.

Look Out for China

One of the more fascinating developments during the first half of the year that we have been watching closely, and believe is worth flagging to our investors, is China's ambition to price oil in Renminbi (RMB) or Yuan, depending on who you speak with. To understand why, we must step back briefly to discuss the how oil became priced in U.S. dollars and why a potential transition from the *petrodollar* to the *petroyuan* would have significant ramifications for foreign exchange markets and the US economy.

In the wake of the Bretton Woods collapse in the early 1970's, Richard Nixon and his Secretary of State Henry Kissinger struck a deal with the Saudi royal family, offering military aid and equipment in return for the Saudi's to price their oil exports in US dollars. The magnitude of this deal cannot be understated; any counterparty looking to trade oil must hold US dollars. One result of this situation (and the fact that commodities in general are priced in US dollars) has been the tendency of foreign institutions (both corporate and government) to recycle billions into US treasury's, and in doing so, fund US government deficits for much of our nations recent history.

In late March, China launched their RMB denominated oil futures in Shanghai, looking to establish a pricing benchmark on equal footing with Brent Crude and West Texas Intermediate. The Shanghai International Energy Exchange (INE) contracts are the first channel for offshore investors to trade in onshore Chinese commodity markets, with deposits and capital gains being transferable back to offshore accounts. The government has also announced plans to waive income taxes for foreign investors trading new contracts for the first three years.

Trading volume has risen steadily since March, with average daily volume of 69,055 lots[3] in April and 170,554 lots in May [147% month on month increase]. While showing modest success, INE still trails considerably to the two leading benchmarks, both NYMEX light sweet crude and ICE Brent have average daily trading volume of more than 1 million contracts a day.[4] Despite the limited volume, major global participants are taking note. Unipec, the trading arm of Asia's largest oil refiner Sinopec, has already signed a deal to import Middle East crude priced against the newly launched Shanghai crude futures.

By no means will the process of replacing a dollar denominated oil system be fast. Close to 90% of all transactions in the $5 trillion dollar a day foreign exchange markets have dollars on one side of the trade, compared to 4% use of the RMB, the significance of which is to be found in the ample liquidity that such a volume of trading implies.[5] Close to 64% of the world's sovereign currency reserves are denominated in

[3] INE counts each side of the trade – the buy and the sell – as two lots. One lot is equivalent to 1,000 barrels.
[4] With open interest at ~2.6 million contracts.
[5] Bank of International Settlements (BIS) and Reuters

dollars, compared to only 1% being denominated in RMB. In addition to scaling the global liquidity of RMB, Chinese capital controls and transparency are still a concern. A firm looking to purchases Chinese goods in the short term may choose to hold the RMB, but holding the RMB for the long-term results in significant foreign exchange risk.[6]

The road ahead may be tenuous, but to price essential commodities in a currency the Chinese can print without relying on the U.S. monetary system is very valuable to Chinese leadership. China is now the largest importer of crude oil in the world with 8.4 million barrels per day in 2017.[7] China is also aware that the U.S. has, conservatively, $100 trillion of off-balance sheet liabilities in the form of unfunded entitlements over the next twenty years. If oil is priced exclusively in dollars, and the U.S. must print $100 trillion to meet their obligations, it is reasonable to conclude that the price of oil will inflate considerably. With roughly $3-4 trillion in foreign exchange reserves, the Chinese may experience a significant loss of purchasing power (measured here by how many barrels of oil they can buy) because of the US need to fund future unfunded liabilities. This would suggest that the government is highly motivated to continue to increase global RMB liquidity, in part to protect their growing energy needs and the purchasing power of their vast USD denominated currency reserves.[8]

What is particularly troubling is that if the US has to finance its own consumption, absent the significant inflows of foreign held US Dollars into US Treasuries that arise from the need of most foreign institutions to hold stocks of US Dollars for future commodity purchases, the resulting domestic economic growth will likely be weak. The net effect of moving the oil trade out of dollars and into the RMB is estimated to remove $600 to $800 billion worth of transactions out of the dollar. In conjunction with a decline in the U.S. labor force participation rate and decade low savings right, we continue to see signposts for a weak U.S. growth and a secular decline in the U.S. dollar.

As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We know that entrusting hard-earned capital to an emerging fund is difficult and hope that you will not hesitate to reach out if you have any questions or concerns about what we are investing in.

Sincerely,

Will Thomson Chip Russell

[6] China has for many years looked to curb capital outflows and have placed restrictions on exchanging large quantities of RMB for the USD.
[7] Compared to 7.9 million b/d in the U.S. in 2017.
[8] The United States in the 1970's was the largest importer of oil in the world and arguably constructed the deal with the Saudi's for principally the same reasons.