Dear Clients,

2016 was a pretty good year. I'm hoping for a better 2017 – the market is acting well relative to the strategies that I employ.

One note: though I have completed my submissions to the State of Maryland regarding their examination of my firm, I have heard nothing back from them. I expect them to say something to me regarding Aleph Blog even though it is not a part of the business. Aside from that, I have no idea about what they might say.

On to the fourth quarter of 2016 – it was a great way to end the year. The portfolios benefited from the election result, but political views don't underlie my strategies. I did not back Trump or Clinton, and I still don't.

Personally, I think Trump will get frustrated by the fact that economies don't behave the way governments expect that they will in reaction to government policies. He wouldn't be the first one to get that problem – even the Communists found that things didn't work anywhere near as well as they expected when they set up command economies.

Trump can sign executive orders and tweet as much as he likes. The legislative and executive branches will have their say as well. Eventually parties will ignore threats over Twitter the same way that parties stood up to Eliot Spitzer and his use of media to shame people and firms into compliance. Virtually everyone that Spitzer took to court ended up winning. The same will prove true for businesses that Trump tries to push around unless he gets new laws from Congress.

Aside from that, it will be interesting to see what effect Trump's efforts to rework trade to make it "fair" will have on global capital flows. When goods don't flow across borders as much, the same applies to capital – there is less need for it to flow and balance things out.

Given the relatively heavy indebtedness of virtually all governments around the world, there is some risk that if capital doesn't flow smoothly, some country will suffer a payments crisis… I have no idea which one, but it will have to be one that finances mostly using US Dollars. The current strong Dollar will make it tough to pay things off.

Also, a reduction in trade will likely slow global growth further, but the degree of that slowdown will depend on the type and effectiveness of the policies employed. It does not change my view that stocks in the US are more expensive than those in foreign countries. As such, you should continue to see a high level of foreign stocks in the Stock strategy.

One final note: we are late in the credit cycle, so I am placing more emphasis on strong balance sheets. I want the companies to be able to fund themselves for three years should a panic event hit the markets.

Stock Strategy

Apx Gross Returns	2016	4Q2016	December
Stock Strategy	16.92%	9.00%	1.22%
S&P 500	12.00%	3.95%	2.03%
Difference	4.92%	5.05%	-0.80%

In November and December, I bought 3.4 new positions, and sold 3 positions.

Purchases:

1) Magna International [MGA] – Based in Canada, Magna is one of the largest auto parts manufacturers in the world. Magna makes virtually every common part that goes in cars; if they wanted to, they could build their own cars, but they don't want to be in that business. They sell to all of the major automakers.

They have an exceptionally strong balance relative to their competitors, which is wise in a cyclical industry. It trades at roughly 8x 2016 forecast earnings, and 6.7x 2018 earnings. Unlike many of their competitors, they rarely have a losing year.

The auto industry is in ferment with new propulsion and navigation technologies. There are a wide number of potential and new entrants like Tesla. Those that make the parts will not be obsoleted, especially Magna. This is an interesting investment, because expectations are low, and Magna's competitive position is strong.

2) Net 1 UEPS Technologies [UEPS] – UEPS is based in Johannesburg, South Africa. They have three operating segments: South African transaction processing, International transaction processing, and Financial inclusion and applied technologies.

Think of a company that is trying to facilitate payments for goods and services, with a few twists. They service poorer people with their unique needs. Many of the people that they serve interact financially through their mobile phones; they help to make the transactions secure through the technology that they have developed. They provide, credit, debit and cash cards.

It has almost no debt, and trades at 1.0x book and 7x 2016 earnings. It has been a slow grower, but again, there are low expectations here. It has made money consistently over the past 12 years.

If I had a criticism of the company, it would be that they are trying too many initiatives in too many markets. With focus, some really interesting positive surprises could accrue to investors. There are a lot of positive factors in the company's favor: a growing global lower to lower-middle class that needs basic financial services, and it is an underserved market. There is a lot of potential for growth here.

3) COPEL – Companhia Paranaense de Energia [ELP] – ELP generates, transmits, distributes and sells of electricity in the State of Parana, which is the fourth largest State on an economic basis in Brazil, just south of Sao Paulo.

I like investing in Brazil because it is a mess. It was one of the best performing stock markets in the world in 2016. (As an aside, one of the few that was better was Russia. The ETF that we owned through all of 2016 – the VanEck Market Vectors Russia Small-Cap ETF [RSXJ] was the best performing ETF in 2016 – it held all of the best of Russia because it does not hold many energy companies. We still hold it because market conditions are still improving in Russia, and it barely trades above book value.)

Back to ELP – It's basically an electric utility, though it does a variety of other things – telecommunications, natural gas delivery, production of wind power, and water and sewage services. It trades for 60% of book value, 13x 2016 forecast earnings and 5.5x 2018 forecast earnings. Unlike utilities in the US, it still has growth opportunities – earnings have grown at a 9% rate over the past seven years. It has moderate debt like most utilities do. They consistently earn money – I can't find the last year that they lost money.

There is the possibility that there could be some reconciliation of business lines at some point, which could lead to greater focus and still greater profitability. That would come at the behest of their largest shareholders, the State of Parana (59%) and BNDESPAR (26%), a wing of the Brazilian Development Bank. I'm not holding my breath there – I think it will be a good investment without any capital structure changes, but politics are volatile in Brazil, and who knows if a privatization wave could happen? Not likely, but a potential upside kicker.

3.4) New Windsor Bancorp [NWID] – This is a bitty bank located in beautiful Taneytown, Maryland. (Non-local Marylanders pronounce it Tahneetown. Locals pronounce it Tawneetown… Maryland has an interesting rural culture that most people who aren't locals would never think existed in such an urbanized state on the east coast of the US.) The bank is being bought out by ACNB Corporation, a bank holding company based in Gettysburg, Pennsylvania. The transaction should close around mid-year; ACNB Corporation has significant reasons to complete the transaction. It should not fall through.

It's unlikely that this will become a full sized position because the stock is not very liquid. At present it is 40% of the size of a normal position.

ACNB Bank is a growing local banking franchise. Earnings have been growing at a 6% rate and it trades at 1.5x book and 15x trailing earnings. I traced the earnings back to 1990, and it has never lost money; that doesn't guarantee that we will make money on this investment.

Sales:

1) Oak Associates [OAK] – I still like Oak Associates. They are a talented manager of assets. That said, they are a master limited partnership, and Interactive Brokers has taken over custody of IRA assets at their firm. They do not accept Master Limited Partnerships in IRAs. That's why I had to sell the position.

I might have sold it anyway, as their profitability has been lackluster. OAK has one special quality though – it tends to do well during crises, because they are a leading manager of distressed debt.

2) Gafisa, SA [GFA] – I mentioned above that we are in the last phase of the credit cycle, and as such I have gotten more conservative about the balance sheets in the portfolio. Gafisa was going to pay down a lot of its debt with the proceeds from its expected sale of its Tenda subsidiary. There was a lack of interest for the sale of Tenda, and as such I felt less comfortable with Gafisa so I sold.

COPEL is a much safer company, and at this phase of the credit cycle, safe is a very good thing.

3) CF Industries [CF] – I committed three errors here. The first was a balance sheet that was not horrible, but not good enough given business conditions. The second was buying it before merger that was cancelled that would have lowered its tax rate considerably. The last was weak pricing for Nitrogen fertilizer. I didn't expect that it would fall so far.

CF's competitive position as a low-cost producer preserved the company, and kept us from having worse losses than we would have had otherwise. That said, in this environment the balance sheet is too weak for me.

None of these three that I sold were killers in terms of losses. Our stocks that gained more than made up for them. 2016 was a good year for us.

Bond Strategy

Apx Gross Returns	2016	4Q2016	December
Bond Strategy	6.13%	-1.38%	0.63%
Barclays Aggregate	2.41%	-3.12%	0.25%
Difference	3.71%	1.74%	0.38%

The bond strategy continues to avoid most risks. We aren't taking much credit risk; credit spreads are pretty low, particularly for high yield. Most of the bond funds held are very short in average maturity. If interest rates rise, we shouldn't be hurt much. The strategy yields around 2%.

The only significant risk we are taking is that of foreign exchange risk – we are long Swiss Francs, and short the Euro and Yen. It's kind of an odd mix, but I can't see Europe or Japan tightening monetary policy much.

I am watching the markets for economic weakness. If I get a sense that growth or inflation will weaken, I will buy some long Treasuries again. It was a good thing heading into the election that I had sold all of the long Treasuries – they got hit pretty hard as the market began to expect more growth, inflation, and more borrowing by the US Government.

I expect that the Fed will get a negative surprise from the bond market around mid-year that will lead them to stop tightening. If we don't get that, we will have a boring year but hopefully profitable year with our short bond funds.

Closing

I can't promise you that the value effect is returning, no one can, but I am grateful for the good performance. If you have friends dissatisfied with their investments, I would be happy to talk with them.

I appreciate having all of you as my clients. Below this is the January update.

David

Aleph Investments January 2017 Update

Stock Strategy -- The Top Five and Bottom Five

Company Name	Ticker	Return
CSX	CSX	28.3%
Alcoa	AA	27.6%
Cameco	CCJ	20.7%
Arconic	ARNC	20.6%
COPEL	ELP	19.8%
Triple-S Management	GTS	-8.0%
ORIX	IX	-8.0%
PBF Industries	PBF	-17.3%
Navient	NAVI	-18.8%
JC Penney	JCP	-22.6%

In January, the S&P 500 gained 1.9%, and the strategy gained 2.8%. Once again the there was one thing characterizing performance: it was the effects of the recent US Presidential election. The election has led to increased demand for raw materials for building, and many of those stocks are relatively cheap. As such, it didn't take much to get them running.

On the stocks that did well: CSX is being courted by the former CEO of Canadian Pacific, who dramatically improved the railroad. He would like to do the same to CSX, and the company's largest shareholder favors this idea.

Alcoa is the beneficiary of expensive aluminum mining and production capacity shutting down. The price of aluminum has been rising. If you own a cyclical stock in a time where the thing produced is in short supply, it can be amazing. The same is true of Cameco, except that it is expensive uranium mining capacity shutting down.

Arconic has rallied more on the basis of expected improvement in its profitability now that it has spun off Alcoa. Note: Alcoa was expected to be the less attractive of the two when the company broke up. Because of the reduction in competition, and rising aluminum prices, it has been the star.

COPEL has done well because of improving business prospects in Brazil. That said, it should prosper regardless.

Now for what went wrong. JC Penney is in the same problem as all bricks and mortar retailers – they are getting harmed by online shopping. JC Penney is down with all of them, and is attracting a lot of interest from short sellers. I still hold this because they are doing everything right, and the valuation does not reflect it.

Navient fell mostly because of complaints from debtors of mishandling the servicing, and after enough study, I believe them. This could be a serious issue, more serious than currently believed, and so I sold it.

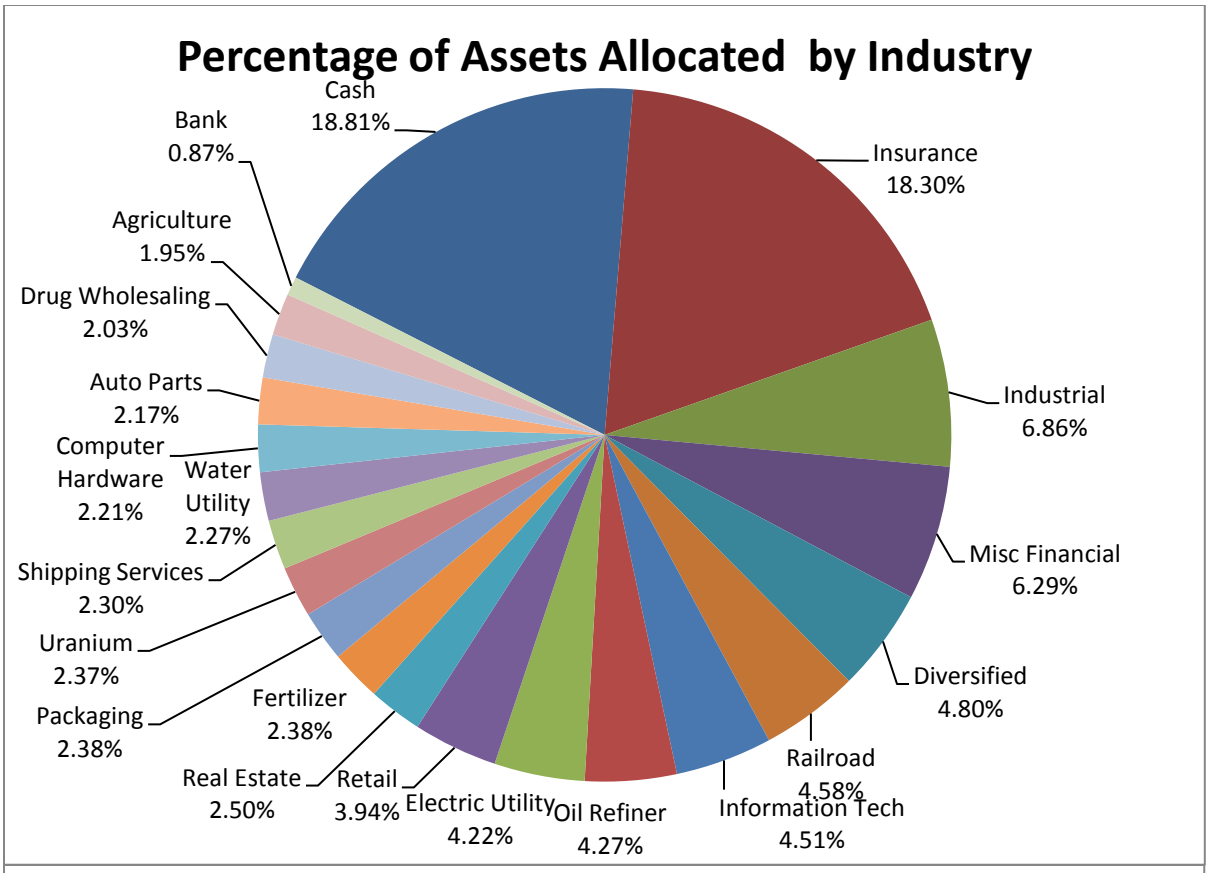
PBF fell because refining margins have decreased. That happens; it is not permanent. ORIX reported earnings, and they were a little low. It's a well-managed company; I'm not worried. No news on Triple-S. I sometimes think that short sellers are attracted to it because it is based in Puerto Rico, but the troubles of Puerto Rico have no effect on GTS – all of their assets are outside of Puerto Rico, and they have profitable healthcare insurance operation inside Puerto Rico that is dominant. I'm not worried.

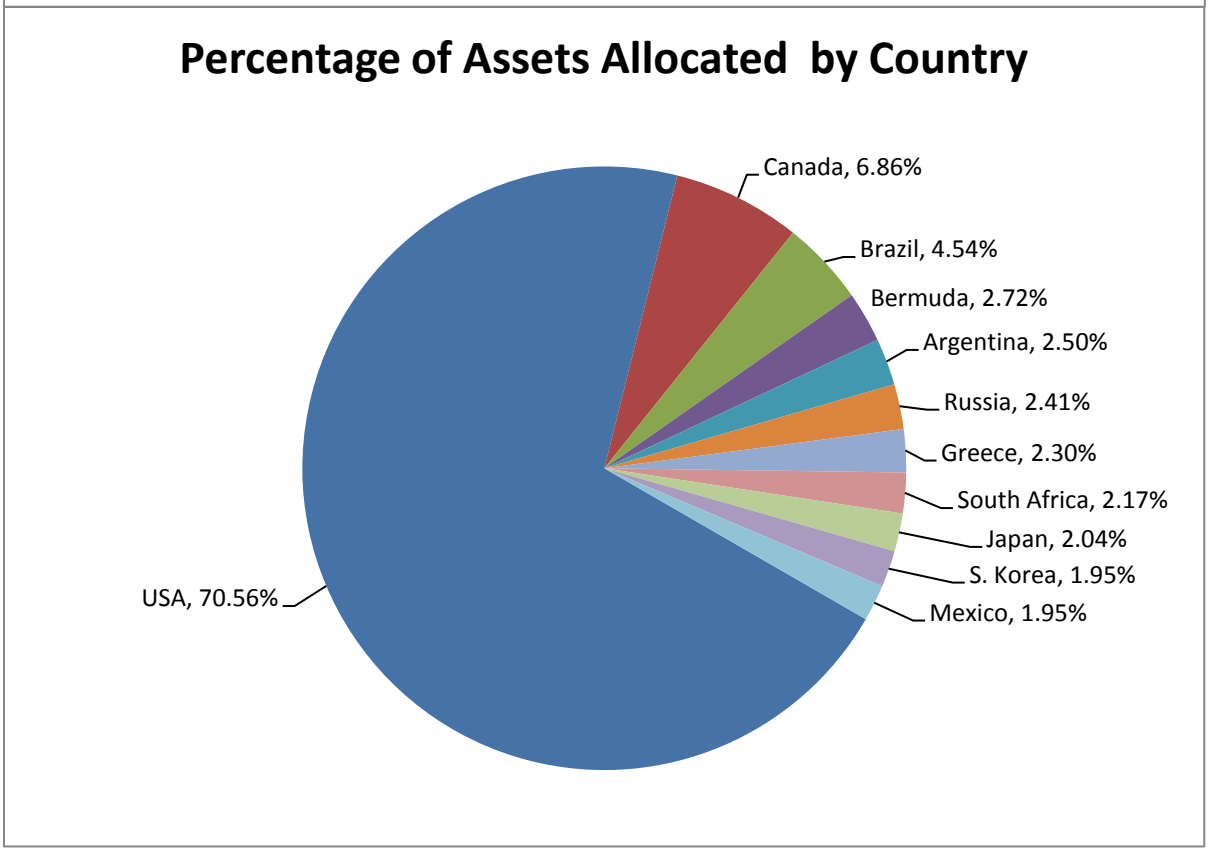
Summary

We'll see what the rest of the year brings. I am focused first on safety, and second on returns. Valuations are high, but not "nosebleed-high." There are still good opportunities to invest in regardless of the environment.

Disclaimer

Note: All figures in this update are estimates, and do not include fees. Your results will differ from these.


Percentage of Assets Allocated by Industry
Cash 18.81%
Insurance 18.30%
Industrial 6.86%
Misc Financial 6.29%
Diversified 4.80%
Railroad 4.58%
Information Tech 4.51%
Oil Refiner 4.27%
Electric Utility 4.22%
Retail 3.94%
Real Estate 2.50%
Fertilizer 2.38%
Packaging 2.38%
Uranium 2.37%
Shipping Services 2.30%
Water Utility 2.27%
Computer Hardware 2.21%
Auto Parts 2.17%
Drug Wholesaling 2.03%
Agriculture 1.95%
Bank 0.87%


Percentage of Assets Allocated by Country
Canada, 6.86%
Brazil, 4.54%
Bermuda, 2.72%
Argentina, 2.50%
Russia, 2.41%
Greece, 2.30%
South Africa, 2.17%
Japan, 2.04%
S. Korea, 1.95%
Mexico, 1.95%
USA, 70.56%

Bond Strategy

Return	Name	Quality	Duration	Currency	Pct	Ticker
0.2%	iShares 1-3 Year Credit Bond	High	Short	USD	19.5%	CSJ
2.8%	CurrencyShares Swiss Franc Trust	High	Short	Swiss Franc	19.5%	FXF
3.5%	Templeton Global Income Fund	High/Med	Med	Mixed	19.4%	GIM
0.1%	iShares MBS	Tsy/High	Med	USD	19.1%	MBB
0.3%	PIMCO Enhanced Short Maturity Active ETF	High	Short	USD	19.7%	MINT
0.0%	Cash	Cash	Short	USD	2.8%	Cash
1.3%	Total	High	Short	USD		

The bond strategy has been doing fairly well; in January it gained 1.3% versus 0.2% on the Barclays' Aggregate.

What went wrong? For one month, nothing went wrong. Everything made money as interest rates rose a little, and credit was decent but not great, and the dollar declined a little. I don't expect this to happen often, but it is nice for a change.

I am watching long bonds for an entry point, but I am in no hurry as inflation seems to be rising globally, and economies are seemingly improving. I'm waiting for the negative momentum to fail.

As an aside, one thing I find fascinating right now is the number of parties piling in to bank loan funds. People are hungry for yield, and losses in these funds are usually small, and people don't want to lose money as the Fed raises rates. Perfect environment for it, if the credit cycle weren't wrong. Maybe this can be the first time in the modern era that we get a scad of corporate loan defaults.

I'm happy with the portfolio for now, and don't expect to make any significant changes aside from long treasuries, and that could be a while.

Closing

Thanks for being my clients. It's possible that things are turning around for value investing generally. It's been a long drought for all value investors, so we will see.

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