Our Mission: To Be Our Clients' Most Trusted Financial Advisor
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EXECUTIVE SUMMARY

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World Update

We are all heart-sick for the events in Paris. Much as with 9/11, the world simply is not as safe as we wish it were. Here's wishing healing for those devastated families and clarity for our leaders in what actions to take. There appears to be a firmer resolve from the developed world to commit more resources to protecting citizens from terrorism.

Market Update

As far as the market goes, it has been a lumpy year for the broad market. Most companies are down for the year. A relative few darlings have carried the S&P 500 to a marginal gain for the year to date. This can be seen by comparing the Value Line 1500 index (a broad-based equally weighted index – each stock counts equally) and the Nasdaq 100 (which is even narrower than it sounds as it is market cap weighted – each stock counts in proportion to its market capitalization). The Value Line 1500 is down 7% for the year while the Nasdaq 100 is up 10%. Corey calls this the "fang" market (FANG - Facebook, Amazon, Netflix, Google).

While the media frets about whether the Fed will raise interest rates, the markets are tightening already. Oil prices have been halved. Numerous commodity prices have dropped sharply. China fell 40%. Biotech stocks are down 40%. This is healthy for the market to the extent it takes some of the speculation and excesses out of the pricing structure. After a 5 year rally, we have entered into what we call a "torpedo" market. While the general market level appears about even, under the surface there are some individual stocks taking serious hits; particularly in areas where there was much excitement. For example, Valeant Pharmaceuticals plunged some 70% as aggressive pricing practices have come to light. Twitter has fallen 50% on slowing user growth and weak revenues.

We are more comfortable with well-established franchises. World leading companies like Nestle and Wells Fargo offer steady growth by providing much needed products and services. Even in a digital world, people need to eat and need to bank. Slow and steady wins the race.

Our usual advice still holds. Pay off your debts. Keep enough cash on hand for a few years' worth of living expenses so you never have to sell into a weak market. Invest the balance in quality, wealth-compounding businesses for the long run. As Dick Pecaut loved to say, "Do what works."

Firm Update – Celebrating 55 Years

Many thanks to all those who helped Pecaut and Company toast its 55th year in business in style with a party at the Sioux City Country Club. Special thanks to the 100 or so clients and friends who braved the snow (!) and came out to help us celebrate. Thanks also to Crimson Wine Group for traveling to the heartland to share their fantastic wines: Pine Ridge, Seghesio, Archery Summit, Double Canyon, and Chamisal. Thanks to Corey who was the genius who thought to invite Crimson Wine to come help us celebrate. Huge thanks to Shelby Pierce, our resident party planner, on pulling it all together.

We also debuted our **new book, <u>Save, Spend, Invest, Give</u>.** We want to do our part to improve financial literacy in America, and this book is a small contribution to that end. In addition, we reported that our 8 podcasts (at danielpecaut.com), which reflect the insights of the book in a conversational format, have now received over 3700 downloads in 46 countries! Surprising Finland was #3 with 102 downloads. By way of explanation, we surmised that the Finnish people must be very intelligent.

All in all, it was a blast.

My part in the festivities was restricted to showing up and saying a few words (proving that the staff has a keen sense of my talents and limitations). After thanking everyone, I mused on how the firm came about and how fortunate we've been to have clients that have patiently stayed with us as the firm evolved and grew through all the ups and downs of the market and of life. Having clear ethics handed down from the founders was a major and essential element of the firm's durability. Another key was having Corey Wrenn partner into the firm in 1992. We operate in one of the most intensely competitive businesses around so life expectancies of investment firms are relatively short. That we've lasted 55 years is truly a rarity. We have been blessed.

This thought wasn't shared because I couldn't find a hardcopy, but I know we once had in the archives a tombstone from an early 1980's stock offering from Iowa Public Service (now MidAmerican Energy, a Berkshire Energy subsidiary). Published in the Wall Street Journal, the tombstone announced the offering and showed the names of all the stock brokerage firms in the selling group formed to distribute the shares. In big print there were a couple of large Wall Street firms leading the syndicate. Then, around the edges, there would be a listing of the dozens of other firms participating. Out of 50 or so firms mentioned in that IPS tombstone, only one remains under the same name today: Pecaut and Company.

<u>Papa's Wisdom</u>

I reflected on the history of the firm and how much things have changed. Russell Pecaut (or "Papa" as I called my grandfather) was 58 years old – the exact age I am now – when he started Pecaut & Company with his sons, Dick and Jack, in 1960. However, life expectancies were shorter then, so it would be roughly equivalent to starting a new business at age 68 or 70 in today's terms. That was quite a bold move on his part, and I shared a part of this story in the book (excerpted from <u>Save, Spend, Invest, Give</u>):

Though retired, my grandfather, Russell Pecaut, would come back in the summers and would take me to Bishops Cafeteria for lunch. I was so excited to get my grandpa all to myself. I liked going to lunch with the founder of the firm. I felt like a big shot in my goofy little suit as I ate chocolate ambrosia pie with white meringue on top.

On one such day after we had eaten our lunch, he looked at me and said, "You know, Dan…." His voice changed, and the hair on the back of my neck went up. He had me on the edge of my seat.

He said, "There'll be a couple times in your life where you'll have a big decision to make, and what you do with that will change everything."

He went on and talked about how a local building, the Badgerow building, had come up for sale during the Great Depression. At the time, it was the best class A art deco building around. It was the best office space in the city, no question. He was invited to be part of a partnership that would buy it. He knew it would be a great deal. But he had a wife and young children, and it would have stretched him financially. So he passed. He said a day did not go by when he saw that building and didn't regret not making that investment. As the country came out of the Depression, buying the building would indeed have been a fabulous investment.

He went on to relate that when his sons Dick (my father) and Jack, graduated from college in the mid-1950's, they went into the securities business with him at C.W. Britton. In 1960, they had an opportunity to go out and start their own business, Pecaut and Company. This time he said "Yes." Because his sons were young and didn't have any capital, he took all the financial risk. Since he was in his 50's, if it didn't work, it would be tough to recover. It put him in a *pickle. It was a risk, but he took it anyway since he knew it was the right thing to do. It worked out so much better than he had even hoped. They made money from day one. So that was the lesson: Be aware that there will be some big moments where your choice will make all the difference.*

Crimson Wine

One of our core investing tenets is, *"When you buy a stock, you buy part ownership of a business. So think and invest like a business owner."* A number of our clients own shares of Crimson Wine, since it was spun out of Leucadia National a few years ago. We loved and appreciated that Crimson was willing to come out and share their wines with us in a tasting. We encouraged one and all to go taste like an owner!

Here's Corey's review of Crimson Wine as an investment:

The origins of wine can be traced back to the Fertile Crescent. It is thought that wine was first discovered when the hunters and gatherers of the time accidentally allowed grapes to ferment. A grape is essentially nature's sugar packet and wild yeast is attracted to it. Combine the two and you get ethanol.

Until the mid-70's, French wines dominated the wine world and North American wine was thought to be much poorer quality than European wines. This changed May 24, 1976 at a wine tasting in Paris in what is known in the industry as the Judgment of Paris. In a blind tasting, wines from Napa Valley were judged to be better than wines from Burgundy and Bordeaux, essentially turning the industry upside down.

Crimson Wine (CWGL) $9.05 – through its five different estate-based wineries, is in the business of producing and selling ultra-premium and luxury wines. CWGL has 24.4 million shares outstanding with insiders owning over 18% and continuing to buy, with a book value of $8.41 per share. The five wineries are discussed below.

Napa Valley based Pine Ridge, known for it's cabernet, was established in 1978 and acquired in 2002 by Crimson, owns 158 (140 producing) acres in five different Napa appellations. Oregon based Archery Summit, known for it's pinot noir was established in 1993 and was also acquired in 2002 and owns 103 acres. Chamisal Vineyard, known for it's chardonnay and pinot noir was the first vineyard planted in the Edna Valley. It was acquired in 2008 and has 98 acres near San Luis Obispo. Double Canyon, a producer of cabernet, was established by CWGL in 2008, and has 185 acres south of Yakima Washington in the Horse Heaven Hills. Lastly, Seghesio Family Vineyards, founded in 1895 by Eduardo Seghesio, was acquired for $86 million from the Seghesio family in 2011. Known for it's zinfandel, Seghesio owns 316 acres in the Alexander and Russian River Valleys of Sonoma County.

With almost 8,300 vineyards in the U.S., according to trade publication Wines and Vines, it's important to remember that every wine is unique and the growing region or terroir is one of the most important determinants of character and quality. Top producing regions, much like Iowa farmland, simply cannot be replicated. This has led to ever increasing prices for premium wine properties. As an example, this summer an 88 acre Napa property with 32 planted acres, 20,000 square feet of caves and a 50,000 gallon winery permit, was listed for $55 million. (As a point of reference, Napa based Pine Ridge has 140 producing acres, 34,000 square feet of caves, and a 300,000 gallon winery permit. The carrying value of ***all*** of the property and equipment for CWGL at September 30, 2015 was $112 million with long-term debt of $5 million.)

As well as the underlying land, the drivers of value at CWGL include the brands. The strategic objectives defined by CWGL's president are quality, focus and growth. To that end, CWGL produces a portfolio of highly rated wines focusing on the strengths of the appellations or regions the grapes are grown in including Pine Ridge's Fortis Cabernet and Seghesio's Home Ranch Zinfandel. Additionally, CWGL's growth is augmented by its ability to leverage the back office and marketing functions to support all five vineyards – a luxury not afforded to smaller producers.

From an earnings perspective, CWGL has made money in each of the last three years on rising revenues and case volumes with wines being distributed through wholesalers and directly to consumers. Earnings declined a bit in 2014, as more money was spent on marketing and SG&A expenses. We anticipate that earnings will be lumpy as they invest in growing the business.

The rainmakers for wineries are the winemakers and in the case of Seghesio, the family members. Many of these people can work anywhere or choose to not work at all. It takes a unique talent to manage an organization like this. When asked, each of the winemakers told me they enjoyed working for CWGL and particularly with the current president Pat Delong.

With high quality wines and properties, we believe the future for CWGL is bright. Cheers!

Happy Holidays

"Start each day with thanksgiving for your blessings. A grateful attitude opens doors, opens your mind, and draws others to you."

- *Sir John Templeton*

That was spoken in March of 1991 on a visit to Templeton's offices in the Bahamas. Such profound wisdom. And, indeed, we do feel blessed. To have such wonderful clients. To have had such excellent mentors throughout our careers. To have a great team to work with every day. To have healthy, loving families.

As Sir John recommends, let's remember to count our blessings. Here's wishing each and every one of you a happy and healthy holiday season.

Dan Pecaut Corey Wrenn