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January 30, 2018

Our Performance in 2017

Baines Creek Partners returned -19.06%, net of fees and expenses in 2017. The S&P 500 returned 21.83% including dividends for the same period. To bring the record up to date, the following summarizes the year-by-year performance of the S&P, the partnership results (before allocation of management fees and incentive allocation), and the limited partners' results since inception:

Year	Total Return of the S&P 500[1]	Partnership Results	Limited Partners' Results
2015[2]	0.70%	-19.52%	-20.60%
2016	11.96%	225.68%	175.10%
2017	21.83%	-17.40%	-19.06%
Cumulative Results	**37.34%**	**116.50%**	**76.80%**
Annual Compounded Rate	**11.61%**	**30.67%**	**21.82%**

[1] – Total Return of the S&P 500 reflects changes in price plus dividends.
[2] – 2015 period results begin on February 11th, 2015, the inception date of the Fund.

This nearly concludes (because 2015 was a short year) our first three year period. As mentioned last year we think an investment manager's performance should be based on a rolling three to five year period versus their appropriate benchmark. Thus far we are pleased with the results.

Our stated goal in this partnership is to compound capital at high rates of return over long periods of time while taking less risk than is commensurate with the returns earned, the results of which can be quite fantastic. See the table below that shows the growth of a $100,000 investment over time, compounded at various rates of return:

Rate of Return

Time	6%	8%	10%	12%	15%	20%	25%
5 years	133,823	146,933	161,051	176,234	201,136	248,832	305,176
10 years	179,085	215,892	259,374	310,585	404,556	619,174	931,323
15 years	239,656	317,217	417,725	547,357	813,706	1,540,702	2,842,171
20 years	320,714	466,096	672,750	964,629	1,636,654	3,833,760	8,673,617
25 years	429,187	684,848	1,083,471	1,700,006	3,291,895	9,539,622	26,469,780
30 years	574,349	1,006,266	1,744,940	2,995,992	6,621,177	23,737,631	80,779,357

Although quite simplistic (and perhaps an obvious observation), the effects of slight differences in interest rates over long periods of time never ceases to amaze me. The question then becomes, "How does one achieve these results?" We believe the answer lies in the following investment principles which we adhere to at BCC:

- Definition of Risk
- View of Market Efficiency
- Long-Term Focus
- Generalization
- Concentration
- Fundamental Value Approach

Last year I spent some time speaking to the first two: Risk and Market Efficiency. After reviewing the results, some may be much less interested in discussing philosophical beliefs and much more interested in what happened in 2017. Although important, I think that understanding what we believe will help with the interpretation of results. We are by no means saying that these beliefs are the only way to run money. One of my favorite investors, Howard Marks, actually adheres to specialization vs. our belief in generalization. However, just as one chooses a congregation that is like-minded in belief, I think it is similarly important to choose an investment manager whose philosophies you are in agreement with. We neither have the ability nor desire to be all things to all people. If our beliefs do not align with yours we would much rather you disagree and subsequently leave the partnership than either not agree or not understand and stick around. I think that would lead to a negative outcome for both parties. This year I will attempt to tackle our beliefs in having a long-term focus and being a generalist, not a specialist.

Long-Term Focus

At first glance our performance in the last few years may resemble a Monet, book-ended by two piles of dog mess. This feeling is probably stronger in those who have entered the partnership recently than in those who have been around since the beginning. As of this writing we are up 24.53% since the beginning of 2018. Did value really change this much since the end of the year? Maybe. However, it is much more likely that value was more stable than price. I said last year that it is our belief that an investment manager's performance should be judged on a rolling 3 to 5 year period. Picking a period any shorter would allow chance as opposed to investment skill to distort results. You should hold your investment manager accountable. However, if this is to be done correctly, the unit of measurement must be both reasonable and stated. Would you measure the distance between your home and the grocery store with a ruler? Of course not, that would be insane. In the same way, we believe it would be nonsensical to judge portfolio performance monthly, quarterly or even annually.

To help illustrate this, below I have shifted the calendar by six months to show our year end results reported as of June 30 as opposed to December 31:

As Reported

Year	Partnership Results
2015[1]	-19.52%
2016	225.68%
2017	-17.40%
2018[2]	24.53%

Shifted by Six Months

Year	Partnership Results
Feb 2015 - Jun 2015[1]	4.01%
Jul 2015 - Jun 2016	48.33%
Jul 2016 - Jun 2017	46.35%
Jul 2017 - Jan 2018[2]	19.41%

[1] – 2015 results begin on February 11th, 2015, the inception date of the Fund.
[2] – 2018 results are unaudited internally estimated results through January 30th, 2018.

After doing this, the results appear much more stable, and annual volatility is much lower. Does this mean the portfolio is less risky? Of course not. The portfolio has not changed at all, only the timing of reported results. It is volatility combined with a short holding period that makes an investment risky, not volatility itself. Knowing this intellectually does not negate the effect it can have on one's psychology. Emotion can often trump reason. I think it would be helpful to spend some time illustrating what I mean by this.

Utility Theory

In 1738, a Swiss scientist by the name of Daniel Bernoulli did some ground breaking work on the relationship between the psychological value of money (now called utility) and the actual amount of money. He argued that a gift of 10 ducats to someone who already has 100 ducats has the same utility as a gift of 20 ducats to someone whose wealth is 200 ducats. Bernoulli was right, of course: we normally speak of changes of income in terms of percentages, as when we say "She got a 20% raise." The idea is that a 20% raise may evoke a fairly similar psychological response for the rich and for the poor, which an increase of $200 will not do. Thus, the psychological response to a change in wealth is inversely proportional to the initial amount of wealth.

Prior to Bernoulli, mathematicians had assumed that risks are assessed by their expected value: a weighted average of the possible outcomes, where each outcome is weighted by its probability. As described in last year's letter, this is how we would assess risk at Baines Creek Capital (BCC). For example:

The expected value of a 70% chance to win $1000 and 30% chance to win $200 is $760
(0.7 x 1000 + 0.3 x 200).

Now ask yourself this question: Which would you prefer to receive as a gift, the above gamble or $650 for sure? Almost everyone prefers the sure thing. If people valued uncertain prospects by their expected value then they would prefer the gamble, because $760 is more than $650. Bernoulli pointed out that people do not in fact evaluate gambles in this way.

Bernoulli observed that most people dislike risk and wish to avoid the worst outcome. If offered a choice between a gamble and an amount equal to its expected value they will pick the sure thing. In fact, a risk-averse decision maker will choose a sure thing that is less than the expected value, in effect paying a premium to avoid the uncertainty. His idea was straight forward: people's choices are based not on dollar values but on the psychological values of outcomes (their utilities). The psychological value of a gamble is therefore not the weighted average of its possible dollar outcomes; it is the average of the utilities of these outcomes, each weighted by its probability. The table below shows a version of the utility function that Bernoulli calculated; it presents the utility of different levels of wealth, from 1 million to 10 million.

Wealth (millions)	1	2	3	4	5	6	7	8	9	10
Utility points	10	30	48	60	70	78	84	90	96	100

You can see that adding 1 million to a wealth of 1 million yields an increment of 20 utility points, but adding 1 million to a wealth of 9 million adds only 4 points. He proposed that the diminishing marginal value of wealth is what explains risk aversion; that is, a decision maker with diminishing marginal utility for wealth will be risk averse. Most of our partners consist of entrepreneurs, doctors, lawyers, professional investors and traders, corporate executives, etc. Having been quite successful in your own right you may very well have this diminishing marginal utility for wealth. I would encourage you though not to bury your wealth and go about your life. I believe there is a simple way around this problem that Bernoulli discovered and if you stick with me I promise I will attempt to make my point soon.

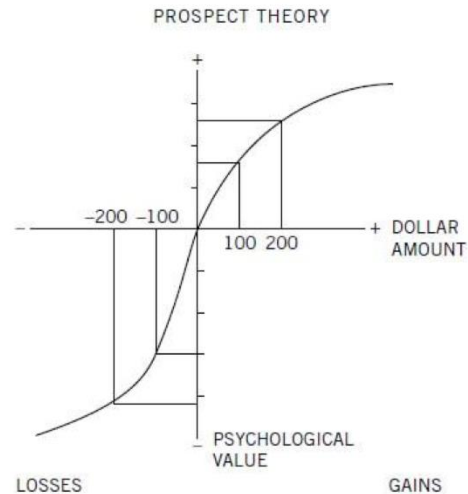
Prospect Theory

Fast forward 250 years to when two gentleman by the name of Amos Tversky and Daniel Kahneman picked up where Bernoulli left off, thinking that he had missed something extremely important. In Bernoulli's theory, the utility of a gain is assessed by comparing utilities of two states of wealth. For example, the utility of getting an extra $1,000 when your wealth is $1 million is the difference between the utility of $1,001,000 and the utility of $1 million. And if you own the larger amount, the disutility of losing $1,000

is again the difference between the utilities of the two states of wealth. In this theory, the utility of gains and losses is allowed to differ only in its sign (+ or -). Possible differences between utility gains and losses were neither expected nor studied. The distinction between gains and losses was assumed not to matter, so there was no point in examining it.

Tversky and Kahneman, however, believed that utility theory was too simple; so they developed what is now known as Prospect Theory, which became one of their most influential works in psychology. One of the main conclusions of prospect theory was that the response to losses is stronger than the response to corresponding gains. This is referred to as loss aversion.

This is illustrated in the diagram to the right. The graph shows the psychological value of gains and losses, which are the "carriers" of value in prospect theory. The graph has two distinct parts, to the right and to the left of a neutral reference point. The S-shape of the curve represents diminishing sensitivity for both gains and losses. Finally, the two curves of the S are not symmetrical. The slope of the function changes abruptly at the reference point where gains turn into losses, or in other words, losses loom larger than gains. This is not only true monetarily but professionally as well. I have heard many professional athletes express how a loss hurts much more than a gain rewards. Another interesting finding in their research was that this relationship held true even when the amount at risk was minuscule relative to the person's wealth. It seemed that, no matter the amount, people just flat out don't like losing.



Let's apply this logic to our own results. Below I breakdown the results of BCC over the past three years by month, quarter, and year based on whether they were up or down. Now, to be fair, I have included results thus far in 2018 as an up month.

Partnership Results
(Feb. 2015 - Jan-2018)

	Up	Down	Total
Months	18	18	36
Quarters	7	5	12
Years	1	2	3

Now, imagine that you have an emotional bank account that only keeps track of your feelings towards your investment with BCC. Setting aside the amount of gains and losses for a certain period, let's assume prospect theory holds true and down months make a larger withdrawal from your emotional bank account than up months make deposits. You don't have to be much of a mathematician to realize your emotional bank account is now negative. However, if you have been with us for the duration of the partnership the value of your BCC investment has grown. Could it be true that one who checks performance often is playing a game they cannot win?

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I heard a portfolio manager on CNBC make the following statement recently, “Oil equities most likely represent good value at these levels. However, they have been extremely volatile lately, and I just can’t get comfortable with this.” I found this to be quite an odd statement but I couldn't really put my finger on why. So it got me asking myself the following questions:

- Shouldn't the relationship between price and value dictate an investment decision, not whether it is comfortable or not?
- Does anything good really come from being comfortable?
- In retrospect - Was I comfortable or uncomfortable when making my best investment decisions? Worst investment decisions?
- Can one be confident in value yet feel uncomfortable?
- Should reason reign over emotion or emotion over reason?
- In investing, what causes one to have confidence?

Howard Marks says that, “a great investment made in comfort is somewhat of an oxymoron.” I said last year, “The judgement that a skillful value investor uses to determine a worthy investment is primarily based on two things: (1) Being able to estimate the dependability and stability of an asset’s value and (2) The relationship between price and value.” I would add to this that one must have a long-term focus in value investing because one doesn’t know how long it will take for this relationship to correct.

Some of our best investments have been made in times of great discomfort, when price greatly disagrees with our view of value. One can be confident yet feel uncomfortable. I am confident that if I go to the gym my waistline will shrink yet the process will make me uncomfortable. It would be much more comfortable to sit on the couch watching a movie and eating ice cream. However, it is my experience that most things that are good in life often come with a degree of discomfort, and a lot that is comfortable has quite the opposite effect. It’s the relationship between price and value that is important when investing and the best prices usually come when there is the greatest amount of discomfort. And just as it takes a long-term perspective to see the value in going to the gym, value investing requires the discipline to look past the current discomfort and the patience to wait for results to be realized.

So this is the conundrum. If it is my goal to maximize my long-term investment results then I must put myself in a situation of discomfort (sacrifice short-term utility). Well, what if I told you there was a way to get the small waist line without going to the gym. I know, now I sound like an infomercial and you would be right to disbelieve. However, I will let you in on a little secret. There is a way to minimize discomfort when it comes to your investment in BCC: you don’t look at the results too often!

Generalist vs. Specialist

In 1953 Isaiah Berlin published a book called *The Hedgehog and the Fox*. The main thesis of the book was a saying from a Greek poet named Archilochus which says: “The fox knows many things, but the hedgehog knows one big thing." In his book, Berlin divides great thinkers into two categories: hedgehogs, who have one perspective on the world, and foxes, who have many different perspectives. It is not merely that the fox knows many things; the fox accepts that he can only know so much about any given thing. The critical feature of foxes is that they are reconciled to the limits of what they know. As Berlin puts it, "We are part of a larger scheme of things than we can understand. We ourselves live in this whole and by it, and are wise only in the measure to which we make our peace with it."

A hedgehog will not make peace with the world. He is not reconciled. He cannot accept that he knows many things. He seeks to know one big thing, and strives without ceasing to give reality a unifying shape. We are divided creatures and we have to choose whether to accept the incompleteness of our knowledge or

to hold out for certainty and truth. Only the most determined among us will refuse to settle for what the fox knows and hold out for the certainties of the hedgehog. The grandeur of hedgehogs is that they refuse our limitations.

The juxtaposition between the hedgehog and the fox was popularized in modern times by Jim Collins in his book *Good to Great*. His so called "Hedgehog Concept" was the intersection of three circles: what you are passionate about, what drives your economic engine, and what you can be the best in the world at. He argued that the good to great companies were all hedgehogs, they knew one big thing and they stuck to it. In contrast, the comparison companies often tended to be foxes, jumping from one thing to the next.

So, should you be a fox or hedgehog?

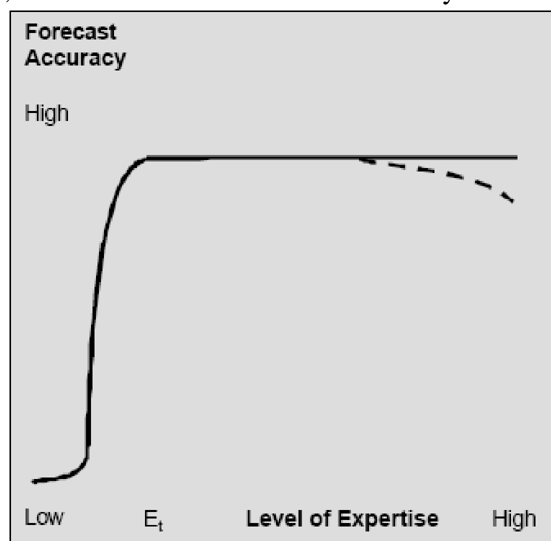
Well, I would say that the answer greatly depends on what you do. If I am to have brain surgery you better believe that I want that surgeon to be a hedgehog. However, if I visit my general practitioner for a pain in my side, I would want him to be a fox. It is our view that the best way to manage money is to be a fox (a "generalist") as opposed to a hedgehog (a "specialist"). I seek to explain why in the next few pages.

Specialist (Hedgehog)

"…the hedgehog knows one big thing." Or at least he thinks he does…

The rise of the specialist within investment management has, in my opinion, largely been caused by the wide acceptance of modern portfolio theory (MPT) in the last 50 years. As discussed in detail in last year's letter, modern portfolio theory is a mathematical framework for assembling a portfolio of assets such that the expected return is maximized for a given level of risk, defined as variance (or put more simply volatility). Its key insight is that an asset's risk and return should not be assessed by itself, but by how it contributes to a portfolio's overall risk and return. Therefore, when constructing a portfolio, one must allocate capital among different asset classes so that the overall portfolio's volatility is minimized based on the desired return objectives. Thus, the specialist (or expert) in every asset class imaginable is needed to help you have the right product to put into your diversified portfolio!

Now, before I go on, I do think asset allocation has it place. One who is retired should probably have five to ten years' worth of their living expense needs in cash or short term bonds before allocating anything to growth type assets. One should not put oneself in a place where they are forced to sell an asset that does not have a stable price at an inopportune time. Remember, it is our view that an asset's volatility does not necessarily make it risky. It is volatility combined with a short holding period that makes it risky. So, in this discussion I am not talking about situations like the above example (nor short-term proprietary or high-frequency trading firms that specialize in a particular type of financial instrument) but rather the portion of one's assets that are set aside for long-term growth.



Are experts who specialize in a particular asset class or sector valuable? Many studies have been done on the value of expertise in a given subject area. Most evidence comes from the field of finance, but studies have also been done in psychology, economics, medicine, sports and sociology. The relationship of accuracy to expertise in a particular field has been measured in various ways - education, experience, reputation, previous success and

self-identification. As shown in the figure on the previous page, expertise above a very low level, and accuracy are unrelated and accuracy may even drop after a certain level due to the expert not truly understanding the limits of their expertise. This minimal expertise that is required to make good decisions can often be obtained quickly and easily.

Many of you who have spent careers developing a special skill set will find this conclusion somewhat unsettling. To clarify, we should ask ourselves the following questions about the wisdom of specialists: When do judgments reflect true expertise? When do they display an illusion of validity? The answers come from the two basic conditions for acquiring a skill:

1. An environment that is sufficiently regular to be predictable
2. An opportunity to learn these regularities through prolonged practice

When both of these conditions are satisfied, a person's intuitions are likely to be skillful. Chess is an extreme example of a regular environment, but bridge and poker also provide robust statistical regularities that can support skill. Physicians, nurses, athletes and firefighters also face complex but fundamentally orderly situations. In contrast, economists, stock pickers and political scientists who make long-term forecasts operate in a zero-validity (noisy) environment. Their failures reflect the basic unpredictability of the events that they try to forecast.

You will quickly notice that I included stock-pickers in the camp where expertise in a particular subject may be less meaningful. The reason is that investors operate in markets, and markets are not sufficiently regular to be predictable (especially highly efficient ones). That is the main reason we tend to operate in areas with structural inefficiencies.

It is our opinion that a specialist's success in investing is just as likely to be an act of luck as it is of skill. The return achieved from investing in a particular sector or asset class probably has more to do with the period in time during which one is investing than any analysis provided by an expert. Put another way, investment acumen is often confused with just being in the right place at the right time. As an example I have listed below the cumulative internal rate of return (IRR) for seven separate funds of a highly prominent venture capital fund here in Austin as reported by the University of Texas Investment Management Company. This venture fund focuses on internet, software, communications and semiconductor investments.

Fund Inception	IRR
1994 Fund	73.17%
1996 Fund	31.91%
1998 Fund	-7.50%
1999 Fund	-4.86%
2001 Fund	1.97%
2005 Fund	-1.74%
2008 Fund	-2.97%

I find it hard to believe that the times were not responsible for the above results. The first two funds rode the wave of the internet boom, while the others were affected by the subsequent bust. I have heard smart people say that the returns didn't suffer from doing anything different. It wasn't that they changed strategy; it was just that prices for deals were being bid up so much that they simply paid too much for the chance to participate. As an investor, I find this statement quite odd. If prices are being bid up too much, shouldn't one choose not to participate…or was this only known in retrospect. And if it can only be known in retrospect, then how could you ever determine value at the time of investment?

A hedgehog investor can potentially fall into the trap of investing no matter what the price is. Most asset-gatherers (financial advisors that receive compensation purely based on the total assets under their management) are hedgehogs. They invest in a certain asset class or industry regardless of price. There is not much skill or cost to doing this. It's a volume game. (Note: It is less expensive for an investor who desires this route to simply go with a low cost index fund.)

It is our belief that buying at a price that is significantly below intrinsic value is far more important than expertise in a particular sector or asset class: a minimum amount of expertise will do. And if one cannot determine value at the time of investment, then they should simply not participate.

To be fair, this is just one example. There are surely some specialists who will succeed over long periods of time. My observation has been that the ones that have succeeded in the past and the ones most likely to do so in the future tend to do both of the following:

1. Operate in areas that are known to have inefficiencies. Examples of this include (but, of course, are not limited to) the following: distressed debt, domestic and foreign small cap equities, illiquid assets such as private equity, real estate and infrastructure assets.
2. Return capital or hold on to cash when opportunities are not present.

Howard Marks' Oaktree Funds falls into this camp. They manage many specialized funds that exhibit the above characteristics. However, in today's world this is hard to find. Although you may find mangers that operate in inefficient areas, there are not many managers that have the discipline to return precious capital when opportunities are not present or to just hold cash. As Warren Buffett has said, "A full wallet is like a full bladder. You may have the urge to pee it away."

Generalist (Fox)

"…the fox knows many things." But he is reconciled to the limits of what he knows.

Purchasing a security in the public markets is an extremely arrogant act. When you do this you are basically saying that you know more than the person selling the security does; if it was such a bargain, why would he be selling it? When looking at an investment I think one should assume that it is accurately priced until it is proven otherwise. Hubris can be quite costly when it comes to investing. As one acquires more knowledge, he can become overconfident in his abilities. Hedgehogs are reluctant to admit that they could be wrong. Nothing makes for better TV than seeing two hedgehogs squaring off against each other pushing their view on the other. Foxes are much less likely to get invited to participate in such debates. They are more likely to say, "I don't know." This does not sell advertising. This is quite a shame because many people's views are shaped by media that is readily available, versus much wiser people toiling far from the limelight.

Federal agents don't learn to spot counterfeit money by studying the counterfeits. They study genuine bills until they master the look of the real thing. Then when they see the bogus money they recognize it. Likewise, when determining what makes a successful investor we should look at the characteristics of a genuine successful investor. Below I take a look at a few of the most successful investors in our generation. They each have track records of 20%+ annualized returns over more than 20 years. You can see that over the past several decades they have found value in a variety of different asset classes. They are most definitely foxes.

If these investors were constrained to a certain asset class or sector their results would have most certainly been poorer. Being an expert in each one of these areas was not necessary, just competence enough to

know if something had the potential to be mispriced. It has been our observation that successful generalists in investing usually exhibit the following characteristics:

1. Look For Easy Games

Being an active investor we must have the view that there is opportunity to outperform the market over time. If we did not have this view we would invest passively and find something else to do for a living. We believe that most markets are highly efficient so we avoid them. We prefer to find easy games, areas where price inefficiencies exist. These inefficiencies provide us the opportunity to buy something for less than it is worth, and once efficiency returns, its price will move towards fundamental value. The challenge is to find an edge: to be one of the smartest players at the table. Many of the areas that Buffett, Klarman and Tepper operate in fall into this category. They consist of obscure assets that can be hard to value, are illiquid, and can likely be acquired from forced sellers. Without going into every category, the following provides a roadmap for identifying situations where we may have an edge:

- Competing against individuals, not institutions
- Competing against investors who buy or sell without regard for fundamental value
- Competing against investors who use simple decision rules

David Tepper

Time Period	Type of Investments
1994	Distressed Debt – single steel company
1996	Preferred Stock
1998	Russian Sovereign Bonds
2000	Structured Derivatives – betting against the dot-com bubble
2001	Distressed Debt
2003	Distressed Debt
2006	Equites
2008-2009	Bank Preferred Stock
2013	Large-Cap Equities

Warren Buffet

Time Period	Type of Investments
1950s - 1980s	Various
Early 90s - Present	Large-Cap Stocks
Late 90s - Present	Entire Companies
2001	Distressed Debt
2008	Distressed Debt
2009	Structured Debt
2011	Structured Convertible Bonds

Seth Klarman

Time Period	Type of Investments
Early 90s	Bank-Thrift Conversions
2001-2002	Equites and Distressed Debt
2007	Credit Default Swaps – bet against credit bubble
2008	Distressed Debt and Equites
2011	Canadian Farm Land
2014	Spanish Real Estate
2017	Puerto Rican Bonds

2. Look For Good Buys Not Necessarily Good Assets.

Experts may have superior skills in evaluating the business prospects of a firm, but this is not sufficient for successful investing. The key question is whether or not all information about the asset is already incorporated into its price. Experts can become overconfident and smitten with a firm's prospects, becoming indifferent about what price they pay. An expert may be extremely competent at finding good assets within his field of expertise, but it may not be a good buy at the time. His expertise could cloud his judgement on making a purchase decision, overlooking the possibility that the asset may be overpriced. Great investors are more likely to ask, "How is the information I possess not already incorporated into the price?" This is what Howard Marks calls "second-level thinking." If someone comes up to you and says, "Apple is a great buy because they are going to sell a gazillion iPhones this next quarter," your next question should be, "Who doesn't already know that?"

3. "Be Fearful When Others Are Greedy And Greedy When Others Are Fearful" - Buffett

Warren Buffett says that if he taught an investing class it would cover two topics: how to value a business and human psychology. Valuing many businesses or assets is not that difficult. Keeping one's cool when the world around you seems to be coming apart at the seams is much more difficult. In investing, temperament is far more important than intellect. Great investments come from both forming a variant

perception and being right. Forming a perception different from the crowd is a difficult thing to do. One has to do his own work and be confident enough in his thesis in order to not be affected by prevailing sentiment. At BCC, we like to run towards areas where capital is fleeing. All great investors that we have observed use human psychology to their advantage.

4. **Hold or Return Cash When Opportunities Are Not Present**
In June of 2007, Chuck Prince (then CEO of Citigroup) made the following statement to the *Financial Times*: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” He was relieved of his duties four months later at the onset of the financial crisis.

An investor’s job is to constantly collect information and decide whether he needs to act on that information or not. This means not acting most of the time because he knows that most of the time he doesn't have an edge. He knows a little about a lot of things but knows that this knowledge has its limits. Most of the time he observes and does nothing. A disciplined investor knows the consequences of becoming impatient and investing at a price that does not provide an adequate margin of safety between the price one pays and the value of the particular asset. The consequence is, of course, permanent capital impairment. Because of this, investors who are generalists will often hold cash or return cash to investors when opportunities are not present. Just because the music is playing doesn't mean one should be dancing.

Most investors find this unsettling. They want their money to be working for them. I think Seth Klarman addressed this problem quite well when he was asked the question, “How do you get such good returns when you often hold up to 40% of your portfolio in cash?” After a moment to think he responded, “Baupost gets such good returns <u>because</u> it holds so much of its portfolio in cash.” The optionality that cash provides allows one to take advantage of opportunities when they come up quickly, when the ability to sell something one owns at a favorable price may not be available. Buffett, Klarman, and Tepper all frequently hold cash in the absence of opportunities and have all returned money to investors at some point in their careers. We expect that at some point we will do the same. However, we have been lucky in the fact that over the three years since inception good opportunities have far outstripped our available capital.

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Now, we are definitely not advocating that everyone should be a fox as opposed to a hedgehog. Quite the opposite really. I believe that most people should specialize in their career. It is in long-term investing where we think that being a fox pays off. The best investors that we have observed have simply not constrained themselves to one asset class or sector. We will not either. I would not be in the investment business if I was forced to choose between Merck, Pfizer, or Bristol-Myers. How does one possibly get an edge in judging between the three largest drug companies in the world? Maybe I’m just not that smart.

Most investors would do better if they simply shied away from assets that everyone loves and bought assets when they are thrown out. You won’t buy at the absolute bottom, and you won't sell at the absolute top, but that’s ok. If you could take on a little more volatility and a little more illiquidity and you only swung the bat when you got a fat pitch, your results would be so much better.

At BCC, we simply try to buy a dollar for fifty cents, or hopefully much less! However, for some odd reason, humans have a knack for turning something simple into something complex. We try to fight the urge to make it harder than it needs to be, and just keep it simple.

Interpretation of 2017

This past year proved to be extremely frustrating. We witnessed an extremely strong showing from the S&P 500 while we watched our portfolio languish. We still remain heavily invested in energy related names, which as a sector was one of the worst performing in 2017. We believe fundamentals in the energy market, especially in oil, continued to improve throughout the year. However, the price of our securities, having finished strong the previous year, stagnated. Throughout the year we continued to try and poke holes in our thesis and we have concluded: that buoy still floats!

One of the most notable things we have discovered over the past few years is how many misconceptions there are about how the E&P (Exploration & Production) business actually works. If one relies on the media for their education on this particular subject, or any for that matter, they will most likely be lead astray. When you are in the business of telling a story, you will often find one even when there is not really one to tell. For this reason we have included an Addendum to this letter as a reference. In it we have attempted to share a general overview of the oil industry as well as our view on the current environment. Warren Buffet's business partner, Charlie Munger has frequently said, "Micro-economics is what we do and macro-economics is what we put up with." We couldn't agree more. However, because we are dealing with a commodity, I believe a discussion on the oil markets is relevant. If you would like to know more about why we believe our thesis in this space is sound I encourage you to take a look.

While prices were down in 2017, I still believe that our portfolio offers tremendous value and that, through patience, we will be rewarded. As I tried to drive home in the "Long-Term Focus" section, I believe that one of the keys to achieving high long-term returns lies in being extremely patient. Combine this with some additional volatility and a little less liquidity and you can end up with a wonderful recipe. One of our investments that fits all three is outlined below. I hope this helps with your understanding of the types of situations we like to look for as investment candidates for the partnership.

Note: It is our policy not to discuss open positions within the partnership. However, Berry Petroleum Company has no active market, and for that reason, we felt confident in disclosing it to you without the risk of harming the partnership. It represents roughly 9% of partnership assets and is the only investment in the partnership that currently has no active market.

Berry Petroleum Company

Berry Petroleum Company ("Berry" or the "Company") is a petroleum, natural gas, and natural gas liquids exploration and production company based in Bakersfield, California. The Company's core assets are conventional, long-life oil properties located in the southern San Joaquin Basin; current recovery techniques include primary, water flood, steam flood, and cyclic-steam production. Berry is the fifth largest producer of oil and gas in California by operated volume.

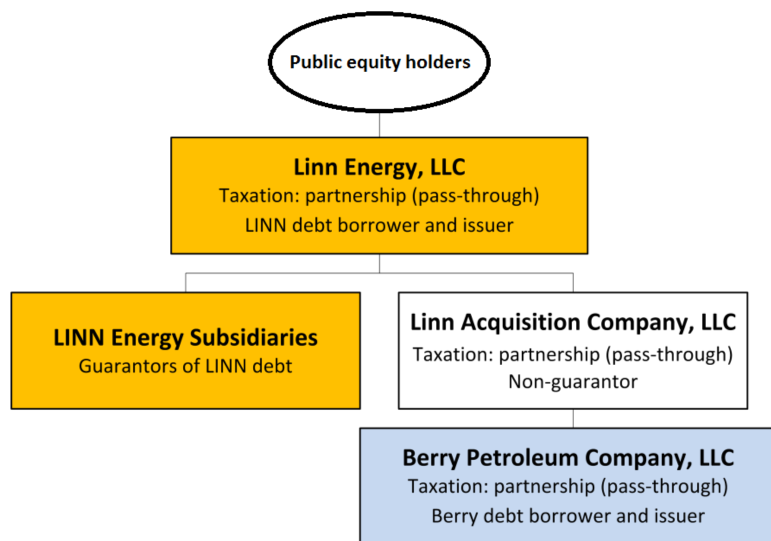
Background Information

Berry was formed by C.J. Berry as a California-based energy company in 1916, and was operated by various Berry family members until the 1980s. The Company became publicly traded in 1987 after acquiring Norris Oil Company. During the 1990s and 2000s, the company grew through acquisitions of properties both in California as well as other states. From 2006-2012 Berry issued several tranches of unsecured senior notes totaling $1.55 billion. In December 2013, Linn Energy ("Linn"), a publicly traded MLP, acquired Berry in an all-stock transaction for $4.6 billion, including $2.7 billion in shares and $1.9 billion of net debt.

At the time of the acquisition, Berry's outstanding net debt position consisted of the following (in millions):

Senior Secured Revolving Credit Facility	$1,200
10.25% Senior Notes due June 2014	205
6.75% Senior Notes due November 2020	300
6.375% Senior Notes due September 2022	600
Total Debt	$2,305
Less: Cash	451
Net Debt	$1,854

Linn did not refinance or assume any of this debt, as might be typical with a major acquisition, but rather Berry became and unrestricted non-guarantor subsidiary of Linn with its own distinct capital structure (as shown to the right). All of Berry's cash was then distributed to Linn, as the sole equity holder, making Berry dependent on Linn for its liquidity needs. Following the acquisition, Linn fully integrated Berry's operations into its own operating subsidiary, and all of Berry's employees became employees of Linn. All Berry operations, accounting, and cash flows were handled by Linn, and it was no longer an operating entity. Linn consolidated Berry's results within its own financial reporting and disclosures, although Berry also continued to file separate public financial statements with the SEC as required by its credit agreement and bond indentures.



During 2014, Linn and Berry became further intermingled through a series of third-party sales, purchases, and asset exchanges involving both Linn and Berry assets. Linn also borrowed $352 million more from Berry via an intercompany advance. By the end of 2015 Linn had repaid the advance and had contributed additional capital to do the following: retire the 2014 Notes, repurchase $67 million of additional Senior Notes, reduce the net borrowings owed on the Credit Facility by $300 million, and fund $250 million of cash for additional collateral under the Credit Facility. This resulted in Berry having the following net debt position at year-end 2015 (in millions):

Senior Secured Revolving Credit Facility	$ 900
6.75% Senior Notes due November 2020	261
6.375% Senior Notes due September 2022	573
Total Debt	$1,734
Less: Restricted Cash	250
Net Debt	$1,484

As the market for unsecured bonds issued by exploration and production companies (E&Ps) began to fall in 2015, the senior unsecured notes of Linn and Berry were among those included in the selloff.

Investment Thesis

We believed that Berry's Senior Notes became mispriced due to its unique, complicated structure and a lack of visibility. Berry's equity had ceased to be publicly traded almost two years earlier. Being buried inside of Linn, having no distinct investor relations efforts, with its only public securities being two thinly traded bond issuances, market awareness for Berry was relatively low. The Berry notes were being significantly discounted because of the poor financial condition of its parent company, Linn. On a consolidated basis, Linn had $8.4 billion in debt, more than $500 million in annual interest, generated less than $500 million in unhedged EBITDA for 2015, and showed negative equity of almost $270 million on its balance sheet at year end. Berry, on the other hand, appeared to still be solvent, showing about $1.8 billion in equity on its balance sheet. Without its consolidated investment in Berry, Linn would have shown an equity balance of negative $2.1 billion. Additionally, in 2015 comparable producing oil and gas assets had been sold for an average valuation of $40,000-50,000 per flowing barrel of oil equivalent per day (boepd). By this conservative valuation metric (which represented much less than half of what these types of assets were selling for just eighteen months earlier), Berry's assets were worth at least $1.9-2.4 billion. Despite having only $1.5 billion in net debt, Berry's Senior Notes were trading at prices that implied a high probability of bankruptcy and a low recovery to unsecured creditors, falling from 100 cents on the dollar to less than 40 between Q3 2014 and Q3 2015. This seemed particularly unjustified since there was only $650 million of revolver borrowings (net of restricted cash) ahead of them in the capital structure. Berry's financial problem was not insolvency but a potential lack of liquidity to be caused by the imminent bankruptcy of Linn, which was hopelessly insolvent. Therefore, we determined that there were only three reasonably likely outcomes:

1. Berry would not file for bankruptcy and unsecured noteholders would continue to be paid all principle and interest as owed, with Linn continuing to operate the company during its own bankruptcy.

2. Berry files for bankruptcy alongside Linn, but Linn would emerge as either the sole or a partial equity holder of Berry with the unsecured noteholders being made whole through reinstated debt and/or new equity.

3. Berry files for bankruptcy, Linn is wiped out as the equity holder, and the unsecured noteholders would own the company. The unsecured creditors would surely be the fulcrum security class (if not Linn, as the equity holder) given that there were enough assets to cover the net claim of the secured creditors three to four times over.

The first scenario offered a yield to maturity of more than 30% through the maturity date of the notes. The third scenario was actually the most desirable, despite the apparent uncertainty it would create in the interim, because the value of the assets net of secured debt (conservatively, $1.25-1.75 billion) was worth more than being paid 100 cents on the dollar for the notes outstanding ($834 million plus interest). The second scenario would offer something in between.

In October 2015, we purchased Berry's 6.75% Senior Notes due in 2020 for an average price of 39 cents on the dollar, valuing the total unsecured notes class at just $325 million (see below).

Senior Secured Revolving Credit Facility	$900
Less: Restricted Cash	250
Net Secured Debt	650
Senior Notes ($834, valued at 39₵)	325
Total Value of Debt	$975

At this price there was a significant margin of safety, given that the value of net assets, even at distressed prices, was well in excess of what we paid for the notes. Berry's net assets only needed to be worth $975 million to cover the net secured debt position and for us to be made whole on our investment, assuming no further interest payments received; this would be a valuation of just $20,000 per boepd. We believed that this investment presented an extreme asymmetric risk-reward opportunity (heads: we win, tails: we win), in which the likelihood of capital impairment was almost nil. In addition, there was also significant upside to asset value following a recovery in commodity prices.

Linn and Berry jointly filed for chapter 11 bankruptcy in May 2016. After nine months in court, Linn and Berry emerged as stand-alone companies. Linn received nothing for its prior investment in Berry' equity. The Berry noteholders received 100% of new Common Stock of reorganized Berry. Through our ownership in the notes we received our pro-rata share of the new common stock and also participated in a $275 million rights offering to purchase our pro-rata share of new 6% Preferred Stock. During 2017, Berry has rebuilt the company operationally, hiring its own board, management, and employees, and completed its transition away from being managed and operated by Linn. Berry is currently a private company and is not registered with the SEC or traded on any exchange.

Given the upward momentum of commodity prices, we estimate that the company could generate unhedged EBITDA in the range of $400-500 million in 2019. Including the preferred shares we purchased in the rights offering and pro forma for their conversion into common stock, the price we paid for the notes implies a purchase price for the company of about $600 million. Adding in the pro forma net debt of $375 million ($650 million in secured debt, less $275 million in rights offering proceeds) represents an enterprise value (EV) of $975 million, or 2.0-2.4 times 2019 EBITDA. Using a conservative 4.0 times multiple of EV/EBITDA implies an equity valuation of $1.2-1.6 billion. Realizing such a valuation by late 2019 would represent approximately a 27-39% annualized return, over a three year investment.

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As of this writing the composition of the portfolio is as follows:

Portfolio Composition
as of January, 30th 2018

Asset	Percentage of Portfolio
Performing Debt	15.9%
Preferred Equities	13.3%
Common Equities	66.7%
Equity Options/Warrants	4.1%

Miscellaneous

As I mentioned last year, Laurel and I have over 80% of our net worth in the partnership. Kevin and Tracy have also dived in head first, with over 90% of their net worth in the partnership. When hearing of the results for 2017, I am sure our wives were left wondering why we spent so much time in the office this past year. You may be wondering if we spent any time at all. I assure you though, with nearly half of the partnerships assets between the two of us, you will be hard pressed to find us sneaking off to the golf course any time soon!

This year we have two new team additions that I would like to fill you in on. Megan Simon joined BCC in early 2017 as our office administrator. She recently moved to Austin from California with her husband and

three children. Megan has brought a tremendous amount of order to our office, so much so, that I am pretty sure it was nothing short of a miracle that we kept the wheels on before she joined us. Welcome Megan!

Later in the year, Jeremy Carter joined BCC to launch a private equity (PE) arm of our business. Jeremy brings with him a career worth of leadership, management, and operations experience in small and medium size businesses. He has hit the ground running. Within a few weeks of coming on board he has managed to launch Baines Creek Special Purpose Partners (BCSPP) whose sole purpose is to invest in one publicly traded company. BCSPP has been met with great success, growing to nearly 10 million dollars in a few short months! If you haven't already, grab a coffee with him; you are sure to learn something. Welcome Jeremy!

As we initiate our PE effort, we could use your help. If you know of a business that meets the criteria below, or could help connect us with people who do, I am confident that Jeremy would love to hear from you.

What we are looking for:

- Growing, profitable companies with $5 million to $30 million in enterprise value and $1 to $10 million in EBITDA.
- Simple, proven business models with consistent earning power. (We tend to shy away from turn-arounds or start-ups, in most cases.)
- Businesses earning a good return on equity, employing little or no debt.
- Strong business cultures and management. In some cases, we can supply managers and support operations, however, we prefer to leverage the team that has built and maintained the value that attracts us in the first place. Note: We are open to businesses in transition where we can leverage our operational backgrounds to help manage the transition and set the company on a path for growth (For example: owners looking to exit, family succession, or corporate divestitures).
- We are primarily Texas focused, but are open to opportunities across the United States.
- The business must be within our circle of competence and easy to understand. Please no bio-techs! Types of businesses that would fit include, but are not limited to, the following: manufacturing, distribution, supply-chain, energy, transportation, and finance (banking or insurance).

It would be our preference to make these purchases in all cash, but as we get started, we may leverage a portion of our investment. Further, depending on the situation, we may be interested in having some of you participate with an equity investment, should you have an interest. To be clear, the main fund does not allow for the purchase of private businesses. We may end up with one through the ownership of publicly traded securities, such as the previously mentioned Berry Petroleum example, but it is not in this fund's charter to purchase a private business outright. Also, my full attention will remain with the main fund. For more information about the PE side of the business visit our website: http://www.bainescreekpe.com/

In the next few months you should receive the following, if you haven't already:

- A K-1 form from Spicer Jeffries for your 2017 federal income tax return (This is the only thing you should need for tax purposes.)
- An audit from Spicer Jeffries of Baines Creek Partners, LP
- A year-end statement of your investment in Baines Creek from Piedmont Fund Services

Now if you have made it this far I congratulate you, however, there is more in store for those of you who also make it through the attached addendum. We are handing out prizes this year for anyone who reads the

letter and addendum in their entirety. If you find yourself in this camp please contact Norman to see what you have won!

We know that there are many options when it comes to investment managers. We appreciate that you have entrusted us to steward a portion of your net worth. If you have any other questions please feel free to reach out to anyone of us on the Baines Creek team.

Cordially,

Brian Williams

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Disclaimers

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Fund performance is independently calculated by our third-party fund accounting and administration service, Piedmont Fund Services, and audited by Spicer Jeffries LLP. 2017 performance is pending the year-end audit. Past performance is not indicative of future results.

Unless otherwise noted, Partnership Results are calculated by taking the gross profit and loss before management fees and incentive allocation accrual divided by beginning capital balance plus any contribution effective at the beginning of the period. Limited Partners' Results are calculated by taking net income after management fee and incentive allocation accrual divided by beginning capital balance plus any contribution effective at the beginning of the period. The net return is calculated based on the Fund as a whole, including the General Partner's portion. Individual investor's performance may be varied based on the timing of contribution and any side letter agreement. Cumulative Results are calculated based on time-weighted return.

Reference to an index does not imply that the funds will achieve returns, volatility or other results similar to the index. The total returns for the index do not reflect the deduction of any fees or expenses which would reduce returns.

Positions reflected in this letter do not represent all the positions held, purchased, or sold, and in the aggregate, the information may represent a small percentage of activity. The information presented is intended to provide insight into the noteworthy events, in the sole opinion of Baines Creek, affecting the partnership.

THIS SHALL NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY INTERESTS IN ANY FUND MANAGED BY BAINES CREEK OR ANY OF ITS AFFILIATES. SUCH OFFER MAY ONLY BE MADE TO A QUALIFIED OFFEREE BY MEANS OF A CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM TOGETHER WITH THE LIMITED PARTNERSHIP AGREEMENT AND SUBSCRIPTION AGREEMENT.