BANYAN CAPITAL MANAGEMENT

February 2, 2017

Dear Client:

Banyan's equity composite was up 10.77% for 2016 while the S&P 500 was up 11.96%. Even though our portfolios slightly underperformed the market, we are mostly satisfied. Last year was especially volatile and provided ample "opportunity" to lose money.
(Explanation of how composite is compiled)

We would also like to remind you of our longer-term results. Over the 26-year period from 1991 through 2016, our equity composite was up 11.3% per year compounded and the S&P 500 was up 9.9%. The success we've had in the securities markets is largely a result of our ability to properly access and control risk. We have a different view of risk verses that of the mainstream. Let's explore how we diverge.

According to academia, risk is the likelihood that a stock's price and, thus, return will deviate from the market return. To make this determination, they compare a stock's historical price volatility to the market volatility. This is a view that has been adopted by many money managers.

We disagree with academia's esoteric views regarding risk in two very important ways:

(1) Risk is not the likelihood that a stock's return will deviate from the market return. Rather, risk is the ***likelihood of suffering a permanent loss of principal.***

(2) Risk is not understood by studying a stock's historical price gyrations. Rather, ***risk is understood by studying the sustainability of a business's economics***.

Due to these differences, we manage risk very differently from most money managers, and this has real implications for your portfolio.

First, by focusing primarily on the possibility of a permanent loss of principal, we are very sensitive to the price we pay relative to the value we receive. The larger the difference, called the margin of safety, the less likely we are to suffer a permanent loss of principal. Therefore, the greater the margin of safety, the less risky the investment, and we demand a *margin of safety* in every investment we make.

Second, since risk is dependent upon the sustainability of a business's economics, we focus our attention on understanding the business's economics and assessing management. If we cannot understand the business or assess management objectively, we cannot appreciate the risk inherent in the investment. If we cannot understand the risk, we will not invest. Therefore, we will not invest in businesses we cannot understand, which means we only invest within our *circle of competence*.

Third, we recognize that business sustainability depends upon the quality of the business and management's capability. A business with great economics can better withstand economic vicissitudes and counter competitive threats. Better yet, outstanding managers will view economic downturns as opportunities to enhance earnings power. Therefore, the likelihood of a permanent loss of principal (i.e. risk) depends on the quality of the business and management's capability, which is why we focus on *outstanding businesses with exceptional managers*.

The above three principles entail a fourth. Wonderful businesses with exceptional managers are rarely cheap, especially those simple enough to fully understand. In other words, it is difficult to find an outstanding business at a low enough price to offer a satisfactory margin of safety. When such opportunities do arise, however, we take full advantage by *concentrating our resources*, both time and money, on our best ideas.

Lastly, our method of assessing risk (i.e. focusing on business sustainability) molds our investment horizon. In the short-term, stock prices move randomly and depend more on emotions than underlying business fundamentals. Since we cannot anticipate emotions, we cannot assess short-term risk. We can, however, predict how a business's fundamentals will develop over the long-term with a reasonable degree of certainty. Therefore, we view short-term price movements as nothing more than opportunities, and we invest with a *long-term investment horizon*.

It is our goal to ***build permanent wealth*** for our clients. To do so, we focus first and most intensely on managing investment risk, which we do one security at a time. Our unconventional views regarding risk drive our investment process. In particular, it forces us to (1) demand a margin of safety in every investment, (2) refuse to invest beyond our circle of competence, (3) focus on outstanding businesses with exceptional managers, (4) concentrate resources on our best ideas, and (5) invest with a long-term investment horizon.

Sincerely,

Gary L. Watkins
President

Drew D. Estes
Portfolio Manager