(571) 308-6881
http://www.tiddcapital.com

TIDD CAPITAL, LLC

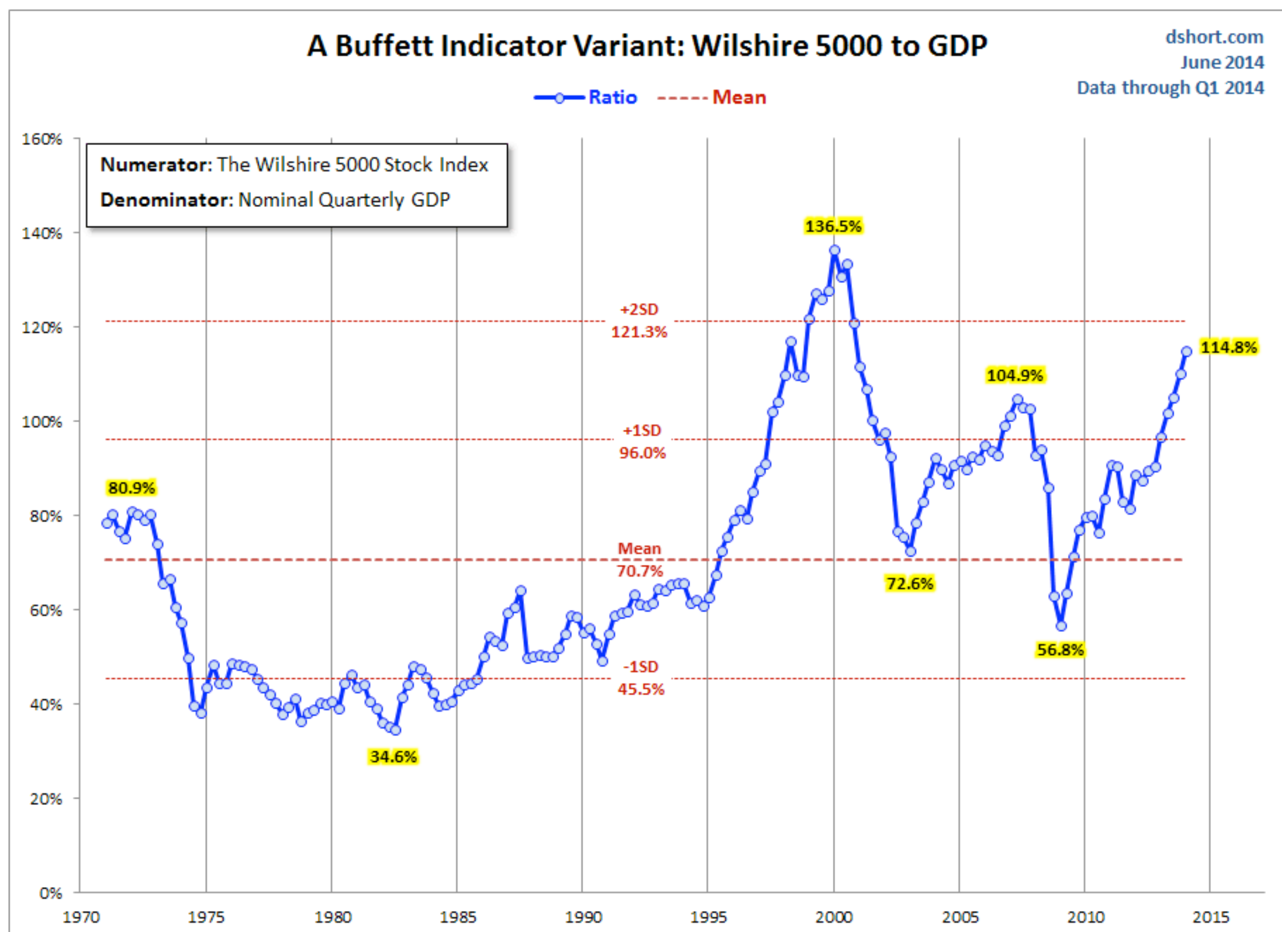
1563 McNeer St.
McLean, VA 22101

Second Quarter 2014

Intro

The market continued its upswing in the first half of 2014, against the backdrop of an economy that is still slowly rehabilitating. Metrics such as unemployment and capital spending are modestly better than 3-12 months ago, but still below historical norms. This in conjunction with the Fed's unprecedented "qualitative easing" monetary policies makes many market observers wonder if the stock market improvements are sustainable. Is this a recovery or a bubble forming?

There are many ways to measure valuation, one way popularized by Warren Buffett as "probably the best single measure of where valuations stand at any given moment" is the ratio of market valuation to total GDP. This is, in effect, the price-to-earnings ratio for the entire US economy. Below is an annotated graph of this ratio going back to 1970.



Source: dshort.com

You can see that the previous two peaks in this valuation metric were at very dangerous times in the market, one was the dot-com bubble of 2000 and the other was the peak of the housing bubble in 2006. Based on this we are in very unpleasant company, the market is essentially valued midway between the high points just before the two worst market declines of the past 45 years.

However in my view there are a few reasons why this is not a cause to panic. First, we aren't invested in "the market", we are invested in 10-15 carefully chosen and monitored businesses. I don't expect the performance of those companies to be 100% correlated with the overall market because they are above-average businesses trading for below-average prices. Second, there is a little bit of slop in this ratio because the stock market is a forward indicator while GDP gains are usually relatively late to arrive during a recovery. If GDP gains do materialize this ratio will come down. Third, while there are clearly areas of lofty valuations in the market such as in technology and momentum stocks like Tesla and Netflix, there are also clearly areas of under-valuation such as in financial and real asset companies, and we are invested only in the under-valued areas. I remember during the previous two market bubbles it was nearly impossible to find any stocks trading at reasonable valuations, and when the entire herd is marching in the same direction it is usually headed off of a cliff. That doesn't appear to be the case today.

I do have a cautious stance towards the portfolios. We are generally sellers and not buyers of securities. We have held a 10-15% cash position for almost 2 years since it has been hard to find new investment opportunities. Paying close attention to market valuations tends to make us buyers in weak markets and sellers in strong markets, and that is the trend today.

Portfolio Updates

Over the past 2 years our investments have generally continued to perform well since they are well-financed companies with competitive advantages and are operating in what is essentially a benign environment. While there are few tailwinds for businesses there are also few headwinds. Inflation is in check, in fact we may be in a slightly deflationary environment, which over a short period of time is good for well-capitalized businesses since it makes their capital more valuable. Unemployment is relatively high but this also means that it is easy for businesses to find new workers and they can be choosy about where and how they hire. Interest rates are very low which means companies pay little on borrowings. This adds up to businesses having a good opportunity to expand.

With almost all of our companies performing well, there has not been a lot of activity in the portfolios. We did initiate a new position in April in Theravance, a small pharmaceutical company, and increased our position in Apple. Following are some updates.

Apple

As mentioned in previous newsletters, our investment in Apple has a very simple thesis that lands right in our investment sweet spot: it is a great company that was trading at an absurdly cheap price. When we bought Apple a little more than a year ago at about $61, approximately 6x earnings net of cash, many analysts were saying that the company had stopped growing and innovating. The value of the stock only made sense if the company's earnings were going to go into permanent decline, like an oil well that was being depleted, which I thought to be very unlikely.

A year later, Apple has shown that it can continue to expand its existing markets and introduce new products and the stock moved up to $79, an increase of 28%. At this price I doubled our position, and the stock now stands at about $92. These numbers are adjusted for the recent 7:1 split. While not as

cheap as it was when we first bought it, the stock does not appear fully valued and we'll be hanging onto it for a while longer.

Theravance

I am not generally much of an investor in biotechnology or pharmaceutical companies, but Theravance represented an unusual situation that I thought we could capitalize on. When we bought the stock in April 2014, Theravance was essentially two different companies, one performing research into new medicines, and another holding businesses associated with already established respiratory drugs. The company had already announced the intention to split into two companies via a stock dividend, as each company would likely have a brighter future on its own. Even though this split-off seemed likely to create value for the two new stocks, the stock unexpectedly traded down about 25% just before the spin-off as part of a broad correction in biotechnology companies, which gave us a great opportunity to buy in.

Industry giant GlaxoSmithKline (GSK) has partnered with Theravance and has provided help with funding, research, development, and distribution. The backdrop is that the industry giants like GSK, Merck and Pfizer have become less involved in developing their own medicines and instead have been acting as more of an incubator for smaller research companies. If and when the research company develops a successful drug, the industry giant will often buy them out, often at a huge premium. This arrangement essentially allows the large pharma companies to lay off some of the risk of developing new drugs while reaping most of the benefits if they are successful. For example just a couple of weeks ago Merck bought Idenix Pharmaceuticals for a whopping 250% premium. While I don't expect that kind of premium for Theravance, being acquired by GSK if their drugs continue to perform well seems like a likely outcome.

So far we are doing well on the position, the research company (Theravance Biopharma) was spun off which I promptly sold for approximately 25% of our cost basis and a small gain. The remaining position is up about 30% so we are in a good position to capitalize on any upside.

Acme United

Some would say that this is the most boring of companies but I've been enthusiastic about this business for over 10 years. Acme manufactures and sells school supplies, knives, cutlery, first aid kids, and various other mundane necessities. The company is very well run by Walter Johnsen and his management team, and have maintained slow and steady progress in expanding and improving the business. They have a solid core position in school supplies which they've expanded by buying well-known brands out of bankruptcy, streamlining their warehousing and manufacturing, and expanding into new markets. The next time you are in Staples or WalMart look for their Westcott brand rulers and scissors or their innovative iPoint pencil sharpeners (yes, really!).

The company was impacted by the economic slowdown but never stopped innovating and expanding, in fact Acme is a great example of a company that continued to improve its business value during tough times, and that paid off as the economy turned to the positive. The stock of this little company (market cap $54 million) is up 128% over the past 5 years and I see plenty of upside ahead.

Acme recently announced a relatively large acquisition, buying the assets of First Aid Only for $13.8 million in cash. This will increase Acme's revenues by about 19% and increase the scope of their profitable first aid kit business. We continue to hold Acme and look for a bright future.

Closing

I hope that this newsletter has provided you better insight into our investments. If you have any questions, please don't hesitate to contact me.

Randall Tidd
President, Tidd Capital
(571) 308-6881