First Quarter 2018 Letter
BRADFORD TOLSON PARTNERS, LP
335 Riverwalk Ln.
New Bern, NC 28560

April 30, 2017

To our Partners,

For the partnership as a whole, the current market value is $736,829.79, and we believe its current intrinsic value to approximate $989,468.49. We estimate the current average annual earning power of the underlying holdings as follows:

Average Annual Earning Power

- Equities Portfolio: $31,663.19; a yield of 11.57% on the $273,748.80 capital devoted to this segment
    - Estimated Intrinsic Value: $526,061.51
- Loan Portfolio: $10,459.32; a yield of 16% on the $65,370.74 capital devoted to this segment
    - Estimated Intrinsic Value: $65,696.63
- Cash & Equivalents: $3,166.19; a yield of 0.86% on $369,966.10 capital devoted to this segment
    - Intrinsic Value: $369,966.20
- Options & Accruals: $0; a yield of 0% on $27,744.15 capital devoted to this segment
    - Estimated Intrinsic Value: $27,744.15
- Partnership Total: $45,288.70; a yield of 6.15% on total capital of $736,829.79
    - Estimated Intrinsic Value: $989,468.49
- Partnership Total Ex-Cash: $42,122.51; a yield of 11.48% on non-cash capital of $366,863.69

Our economic goal is to maximize the partnership's average annual rate of gain in intrinsic value per dollar invested. We will seek to attain this goal by maximizing the underlying earning power of the portfolio overtime, primarily through the ownership of a diversified group of businesses that consistently generate cash. Because we most often deploy capital in publicly traded securities, their market values may fluctuate wildly in any given year because of the psychological vicissitudes of market participants, irrespective of actual value. Therefore, we measure our success by the underlying earning power of our holdings and the growth of that earning power overtime, just as would the owner of a family business seeking to pass it on to their children. ***Psychology determines market prices in the short-term, but it is unpredictable. Earning power, which is more predictable, determines long-term prices. Therefore, as long as earnings are tracking higher, a short-term drop in market prices doesn't phase us. In fact, a depressed stock market would present us with significant***

advantages. A depressed market makes it easier for us to buy stakes in great businesses at attractive prices. Furthermore, most of our businesses regularly repurchase their own shares, and when they repurchase shares at lower prices it leaves us owning a larger slice of their earnings.

In the shorter-term, to achieve our long-term goal, we'll be looking to increase the earning power of the partnership by: 1) maximizing the yield on our cash balances as interest rates rise, 2) seeking opportunities to deploy cash in our lending operation which features high interest rates and substantial collateral, 3) purchasing additional shares in publicly traded equities as they become available at attractive prices.

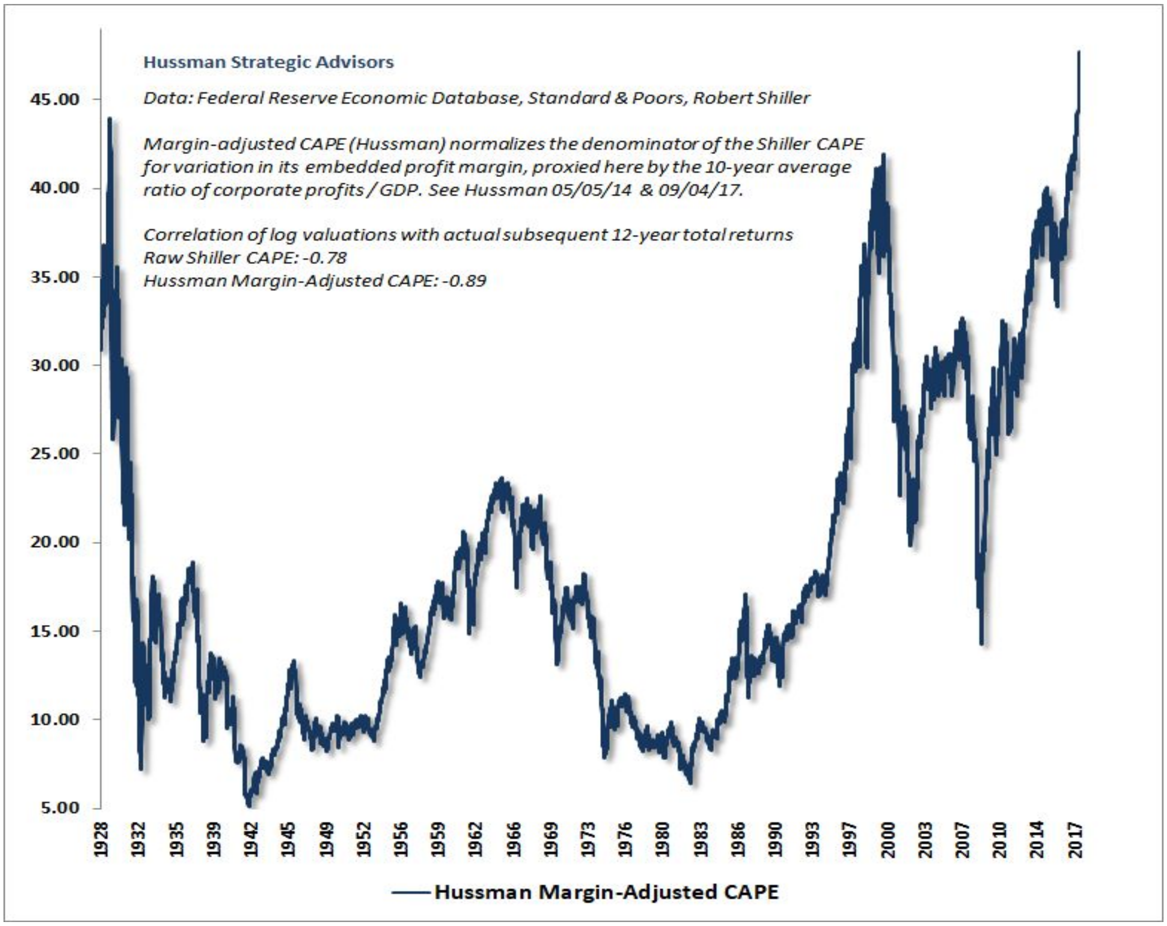
Intrinsic Value

Given our focus on intrinsic value, we'll define it here so that all partners are on the same page. ***The intrinsic value of a business is the present value of the cash that can be taken out of the business over its remaining existence, or put differently- the price that a reasonable private owner would be willing to pay for the entire business.*** The most basic version of this expressed mathematically is that Intrinsic Value=Annual Earning Power/Required Rate of Return. So, if a business produces $100 in cash each year and we demand a 10% annual return on investment, then the intrinsic value of the business is Intrinsic Value=$100/10%=$1,000. For comparison, if we required only a 5% annual return for the same business, then its value would be Intrinsic Value=$100/5%=$2,000. Therefore, the same business may be worth different amounts to different investors, depending on the return they require to entice them to invest. For this reason, sometimes the market value of our portfolio will be less than its intrinsic value to us, and sometimes the market value of our portfolio will exceed its intrinsic value to us. The former scenario is helpful when we are seeking to deploy cash and increase equity holdings, and the latter helpful if we want to increase cash balances via portfolio sales.

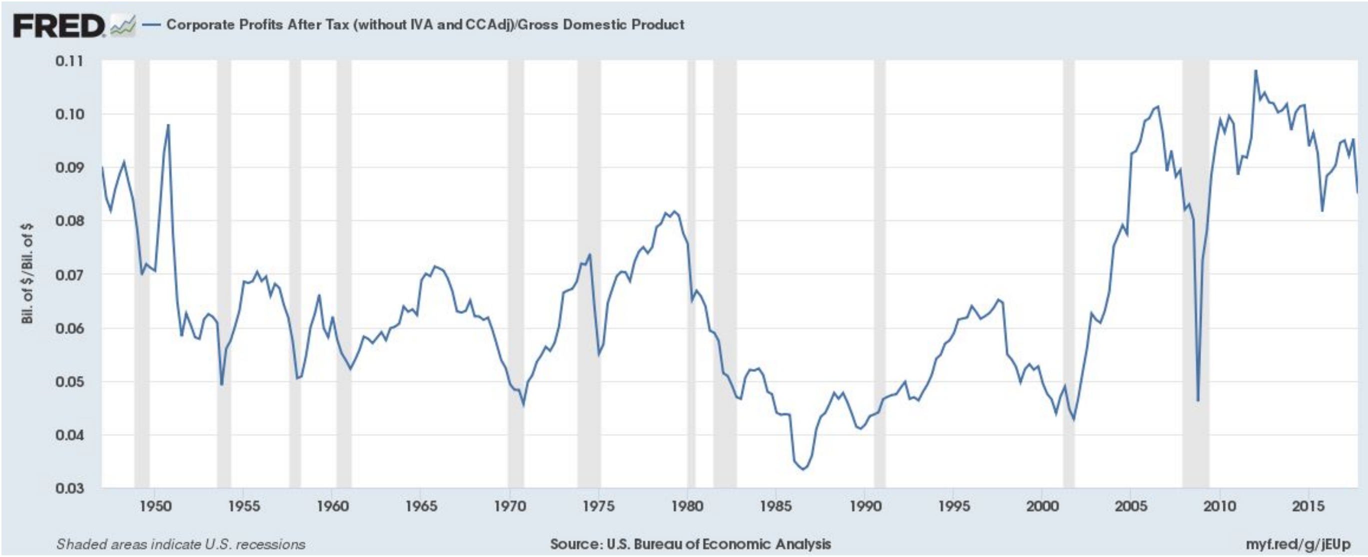
General Market Environment

During the first quarter of 2018 we began seeing signs of a regime change in the stock market. Typically, when market participants are feeling aggressive and inclined to take risk, most stocks move up together in tandem. Conversely, when there is growing dispersion among individual equities, sectors, etc. it is a sign that market participants are becoming increasingly picky and more conscious of risk. There is also some breakdown in market leadership, as 7 of the 10 largest companies in the S&P 500 are down year-to-date. ***Of the companies in the S&P 500, 21% are down at least 20% from their 52-week high, 55% are at least 10% below their 52-week high, and 53% are down year-to-date.*** This return dispersion and market behavior is one way for us to measure growing risk aversion in the market. This growing risk aversion, when paired with lofty market prices relative to earning power, can be the harbinger of coming market declines.

Our view of the general market level is that it is priced far above intrinsic value. In fact, from a quantitative perspective, we believe that the stock market is more overvalued than at any time in history, perhaps excepting the peaks of 1929 and the dot com bubble in 2000. For a nice visual representation of this valuation extreme, here is a chart adjusting the recently famous "Shiller P/E" for normalized profit margins. Margins in 2000 were below their historical average (making stocks appear more expensive than reality), while today's margins are elevated relative to history (making stocks appear less expensive than reality), so the chart paints a good picture of just how extreme current valuations are:



Nerd note: adjusting the typical Price/Earnings ratio, which includes only one year of earnings, to reflect average inflation-adjusted earnings and average margins increases its predictive power for forecasting future 10-12 year returns. Because earnings results from year to year are even more volatile than stock prices themselves, a single year of earnings results has very little predictive use for estimating long term earning power.



The chart above is a proxy for U.S. corporate profit margins, which as you can see are quite elevated relative to history but showing a persistent downtrend since peaking in the first quarter of 2012. Going forward, corporations are likely to continue struggling in their fight to maintain such elevated profit margins due to the combination of a tightening labor market putting upward pressure on wages and rising interest rates. One offset of course are the tax cuts just passed last year. However, we estimate a maximum earnings boost of 12.44% for the S&P 500 (whereas we estimate the market is overvalued by 59-186%) and a maximum increase to S&P 500 net profit margins of 1.14%.

Another factor to be mindful of is that during the dot com bubble, overvaluation was confined primarily to technology stocks skewing the overall average upward, whereas many "old school" companies were trading at very reasonable valuations. Today, the overvaluation is largely present across sectors, leaving few places to hide. Fortunately, the increasing dispersion of market returns has begun resulting in a few companies with valuations attractive enough to at least merit study, primarily in the Healthcare, Financials, and Media sectors. You can see this reflected in the changes to our balance sheet at the end of the first quarter. The current difficulty for investors wary of market valuations is the lack of yield to be found elsewhere. During the dot com bubble 3-month Treasury yields were north of 6%, so at least you could receive an adequate yield on cash equivalents while waiting on the stock market to settle down. Over the past few years, with 3-month treasuries yielding less than both the rate of inflation and the dividend yield on stocks, that alternative has been much less attractive. This has provided a huge tailwind to equity markets, as investors have been required to take on increasing levels of risk to maintain acceptable levels of investment income. Those winds are now changing, ***as the 3-month Treasury bill (a cash equivalent) closed today at 1.87%. The dividend yield on the S&P 500 at today's close? That's right, 1.87%. We think investors will soon be asking themselves whether the additional risk of holding stocks is worthwhile when compared with equivalent yields on cash equivalents.***

Our base case estimate of the S&P 500's fair value is 1377.02, levels last seen in the year 2012. Our highest potential estimate of fair value is 1655.85, last seen in 2013. Finally, our bear case (with both margins and valuation multiples falling to or below historically average levels) calls for a drop to 912.11, not seen since 2009.

Compare these estimates with the S&P 500's quarter-end price of 2640.87, where ***a drop to fair value would require declines of 37-65%.*** If accurate, this overvaluation carries with it the possibility of a substantial decline in all stock prices, both undervalued and otherwise. In any event, we doubt that current market levels will be thought of as cheap five or even ten years from now. In fact, by some valuation measures, current valuation levels have *never* resulted in positive returns over the following 18 month, 3 year, and even 5 year time horizons. The stock market decline through 2002 wiped out capital gains going back to 1997, and the decline through 2009 wiped out capital gains going back to 1996. We expect the second half of this stock market cycle to be similarly devastating and wipe out any gains our conservatism has caused us to miss since starting this partnership. We would welcome a full-scale bear market that results in the market arriving at an undervalued level, as that would allow us to fully deploy our large cash balance in attractively priced businesses of high quality. The resilience of market prices in the face of inflation-adjusted S&P 500 corporate earnings stagnating since their previous peak in 2014 has prompted us to act with growing caution by maintaining our option hedges against market losses, raising cash liquidity, and reallocating capital to investments such as our loan portfolio that lack market correlation. ***We do not make predictions, and we have no idea when the market's valuation will correct itself, but we prefer to play it safe for now and take temporary mark-to-market losses on hedges and companies in the midst of turnarounds rather than having our capital permanently impaired later.***

<u>**Our Asset Allocation in Q4 2017**</u>

Our balance sheet can be broken down into four primary categories:

1. **Cash (50.21% of Capital)**
2. **Equities Portfolio (37.15% of Capital)**
3. **Secured Loans (8.87% of Capital)**
4. **Options Portfolio (3.7% of Capital)**

We are making steady progress toward building an "all weather" portfolio of assets. In case of a continued bull market, our public equity holdings should benefit. Our loan portfolio acts as an anchor regardless of the stock market's direction, producing good returns on capital if we are mindful to be conservative- extending credit only to worthy borrowers with the capacity to repay. During a market downturn, our hedges help to blunt losses in the public equities portfolio, and our significant cash holdings provide an additional buffer. Holding cash also provides us with nice optionality, allowing us to take advantage of investment opportunities as they arise, particularly in the event of market downturns where great companies can be found for purchase at bargain prices. It is likely that we will lag a roaring bull market, but this should be offset by superior relative performance during market downturns, and we hope to take advantage of the combination of complementary characteristics exhibited by our cash, stocks, loans, and hedges to produce attractive absolute returns overtime.

Partnership Market Value Behavior

We expect our worst performance periods, both on an absolute basis and relative to the market, to be at the top of mature bull markets, as in the case of our current 9-year bull market, which ranks second in length only to the dot com bubble in modern history. A few factors drive this: 1) there are fewer undervalued businesses at market tops, giving us less to invest in; 2) because there are less investment opportunities, we will tend to hold more cash and market hedges, both of which will act as a drag on returns if the market continues higher; 3) the few investment opportunities existing at market tops will tend to be more complex and more hated by market participants, such that they will generally perform worse than the market over the short-term until sentiment surrounding them can improve over a period of years. Good examples of the third factor are the "turnaround" situations in our portfolio, such as Valeant Pharmaceuticals, IBM, Viacom, and Pharma-Bio Serv. Given currently extreme market valuations, the combination of these three variables has exhibited itself with force. We therefore believe that our underperformance thus far represents temporary market vicissitudes rather than a permanent impairment of capital. We believe that the intrinsic value of our stock holdings and of our partnership equity generally is far higher than its current market value, and we expect this higher intrinsic value to be reflected in the market values of our holdings overtime. Going forward, we expect our best relative performance to come during market downturns, when there will be more investment opportunities in which to deploy capital and when the combination of our cash and market hedges will have a positive rather than negative impact on relative returns.

Our investment strategy requires both patience and the psychological fortitude to wait out periods of intense volatility, particularly at the top of highly overvalued markets. The long-term result of maintaining our value-oriented strategy should be attractive absolute rates of return, which will reward us amply for any psychological difficulty experienced over shorter time horizons. During the next bear market, we fully expect the relative gap between our returns and the S&P 500 to narrow, and we will work hard to erase it completely.

If you have any questions about our operations, please don't hesitate to contact us, we believe that transparency and well-informed partners will be cornerstones for the future success of the partnership.

Best Regards,

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Balance Sheet

Bradford Tolson Partners as of 3-31-2018		% of Equity
Assets		
Cash, Money Market Funds & Equivalents	$369,966.10	50.21%
Secured Loans	$ 65,370.74	8.87%
Berkshire Hathaway	$ 72,411.24	9.83%
Valeant Pharmaceuticals	$ 57,312.00	7.78%
Pharma-Bio Serv	$ 33,620.55	4.56%
Option Portfolio	$ 27,274.95	3.70%
Wells Fargo	$ 15,723.00	2.13%
IBM	$ 15,343.00	2.08%
Nomad Foods	$ 12,592.00	1.71%
Viacom	$ 11,880.00	1.61%
Brighthouse Financial	$ 11,308.00	1.53%
Cheniere Energy	$ 10,690.00	1.45%
AerCap Holdings	$ 10,144.00	1.38%
Phillips 66	$ 9,592.00	1.30%
Monsanto	$ 1,166.90	0.16%
Mylan	$ 1,029.25	0.14%
Synchrony Financial	$ 1,005.90	0.14%
Platform Specialty Holdings	$ 963.00	0.13%
Western Union	$ 961.50	0.13%
Fiat Chrysler	$ 923.40	0.13%
Walgreens Boots Alliance	$ 916.58	0.12%
General Motors	$ 908.50	0.12%
Bayer	$ 904.16	0.12%
ExpressScripts	$ 898.04	0.12%
Cardinal Health	$ 877.52	0.12%
CVS Health	$ 870.94	0.12%
AmerisourceBergen	$ 862.10	0.12%
McKesson	$ 845.22	0.11%
Accrued Dividends & Interest	$ 469.20	0.06%
Total Net Assets	**$736,829.79**	100.00%