3207 Ranch Road 620 South, Suite 200, Austin, Texas 78738 Tel: (512) 505-2347 Fax: (512) 233-2245

Client Letter – April 29, 2016

Enclosed are your March 31, 2016, portfolio appraisals. Also, as required under Rule 204-3(b) of the Advisors Act, we are enclosing a Summary of Material Changes to our most recently filed Firm Brochure. You may obtain a full copy of our Firm Brochure by calling us at 512-505-2347 or from our website at www.ycginvestments.com/firm_brochure.

After a more than 10% decline over the first twelve trading days of the year, the S&P 500 rallied all the way back to end the first quarter with a 1.35% gain.[1] As we highlighted in our last letter, the 10% decline was the second worst start in the history of the index. At the time, many commentators were arguing that this dubious distinction portended more pain for the remainder of the year. We remained unconvinced, writing, "Frankly, we don't know how 2016 will transpire. Markets are unpredictable in the short run. Over the long term, however, we believe equity ownership should continue to be the best way to grow wealth." We wouldn't change a word and believe the swift rebound is another piece of evidence that supports our strategy of being agnostic about the short term movements of the market and of remaining fully invested as long as we can find businesses priced at levels that we believe will generate attractive risk-adjusted forward rates of return.

We also believe the fear-driven response of many market participants to the sharp correction at the beginning of the year is emblematic of a more generalized misappraisal of the probability of a Global Financial Crisis reoccurrence. As behavioral finance researchers have discovered, the heuristics we use to judge risks are not well equipped for the modern world. One of the most important heuristics that leads us astray is the availability heuristic, which is our mental shorthand for estimating probabilities. Basically, we estimate the probability of an event based on the number of examples that immediately come to mind. The number of examples that come to mind depends on many factors, but two of the most important, and most error prone, are recency and saliency. If an event was recent and/or very memorable, we will likely overestimate the probability of it reoccurring, especially if the event is rare. Thus, people massively overestimate the probability of earthquakes, terrorist attacks, and plane crashes, both in general and particularly after they occur. On the other hand, people generally underestimate the probability of fatal car crashes because, while they are far more likely, it's harder for most people to recall specific examples since they are so common that we don't mentally catalogue each discrete event.

Estimates about the probability of a repeat of the Global Financial Crisis fit into this framework perfectly. The Global Financial Crisis occurred quite recently on the timescale of 1- or 2-in-100 hundred year

[1] For information on the performance of our separate account composite strategies, please visit www.ycginvestments.com/performance. For information about your specific account performance, please contact us at (512) 505-2347 or email info@ycgfunds.com.

events and was incredibly salient because of the depth of the losses and the widespread panic it engendered. Thus, a recurrence is likely, in our view, to be similarly overestimated. We can see this impact in the portfolio insurance market. Before the crisis, portfolio insurance on mortgage-backed securities and banks was incredibly cheap and made many millions for the people who bought this insurance. Now, there are movies about these people and huge numbers of investors buying all kinds of insurance, all trying to get their own big score or to protect their portfolio from financial ruin. Whether it's protection against Japan's currency weakening or credit default swaps on European bonds or financial instruments that pay off in the event of a student loan market meltdown, Wall Street these days almost always has a "cheap" insurance product for sale.

A kind of mirror image of the overvaluation of portfolio insurance is the undervaluation, in our opinion, of the U.S. banks. Because of the losses and emotional trauma that many bank stock investors experienced during the Global Financial Crisis, the current conventional wisdom is that banks are unanalyzable, fragile institutions that have to take big risks with lots of leverage in order to make good profits. While it's true that management teams can make the banking business complex and risky if they chase after the last dollar of profit through reckless means or use extreme amounts of leverage, we believe, contrary to the conventional wisdom, that banks can make very good returns on equity with fairly low risk if they keep their activities simple and focus on improving their numerous structural advantages. Wells Fargo, the bank we've chosen to own, is a great example of a simply run bank that has generated wonderful returns for shareholders over time.

Wells Fargo

Wells Fargo is the fourth largest bank in the United States, with over $1.8 trillion in assets and $1.2 trillion in client deposits. Wells Fargo generates income by using the deposits of its banking clients to make mortgage, commercial, industrial, and other types of loans to corporations, small businesses, and individuals. In addition, it invests some of this money into corporate, government, and asset-backed debt securities. It then makes a spread on the difference between the rate of return it receives on investments and loans and the rate of interest it must pay out to its depositors. Additionally, Wells Fargo generates a large amount of income off of fees it charges for the various banking services it provides.

The reason borrowing money and then lending or investing it is such a good business for Wells Fargo, and for most other banks as well, is because of the advantaged borrowing costs banks have relative to other borrowers. If a non-bank corporation wanted to make the loans that banks make, it would have to raise the money in the credit markets. In the credit markets, investors benchmark every potential investment against the so-called risk-free rate, which is generally considered to be the rate at which the U.S. government gets to borrow money since its ability to print money and tax U.S. citizens makes it very unlikely the government will ever default. Since investors can lend money to the government at the risk-free rate, a non-bank corporation would have to pay its debtors the risk-free rate plus a premium based on the credit markets' assessment of the extra risk they're assuming. To make matters worse, a prudent non-bank corporation would have to match the duration of its borrowings with the duration of its loans. In other words, if it made a four-year loan, it would have to raise four-year debt. Unfortunately, borrowing money for longer raises the cost of debt, and, thus, this duration matching would narrow the profitability of the non-bank corporation's borrowing and lending business further. It could try to raise two-year debt, but, since the loan it made was a four-year loan, it would have to "roll" the debt at the end of the two-year term, meaning it would have to convince the credit markets to let it borrow the money for two more years. If the credit markets were scared about the loans when the non-bank corporation needed to raise this financing, it may not be able to raise the money at profitable rates or even at all, which could cause the non-bank corporation to go bankrupt. Also, the borrowers would probably raise the cost of the two-year debt anyway to account for the risk that the non-bank corporation could potentially decide to make the four-year loan.

Contrast this experience with Wells Fargo's and other banks' experience. For a number of reasons, the most important of which being that the government guarantees their deposits up to $250,000 per account, banks are able to raise money at shorter durations and for a much cheaper price than non-bank corporations can. In fact, banks normally borrow money at *below* the risk-free rate. This scenario occurs because of the combination of the government-guarantee with the value that banks provide to depositors through 1) the liquidity of their accounts, 2) the convenience of account access as a result of bank branches and online support, 3) the ability to manage numerous financial products all at the same place, and 4) the trust and comfort that develops between bankers and their customers. Additionally, the nominal amounts of money that many customers have in their checking accounts and the hassle of switching banks makes many customers less focused on the interest rate they are being paid on their deposits. This structural funding cost advantage relative to other market participants enables many banks to earn returns significantly higher than their cost of capital over time. Unfortunately, some banks are not content to earn very good returns and take too much risk on their investment securities and loans or use too much leverage, leading them to subpar returns over a cycle and sometimes even to bankruptcy.

Given this industry backdrop, the reason we like Wells Fargo is because it has an even better structural funding cost than other banks, and it also has a strong culture of conservative risk management. The combination of these characteristics has enabled it to generate higher returns than other banks over economic cycles and, importantly, to be much more resilient in downturns.

First, on the funding side, the main differences between banks arise based on two factors: their success in 1) raising low cost deposits and 2) selling as many different products to each customer as possible. Wells Fargo is one of the best banks in the country at accomplishing these tasks, allowing it to achieve a lower funding cost than most of its competitors. This funding cost advantage is hard to overestimate. Because of its lower funding cost, Wells Fargo's management feels much less pressure to stretch on credit standards when other banks are taking too much risk since it can earn similar returns on equity as other banks even with lower yielding loans and securities. Additionally, Wells Fargo's management has long cultivated a culture of conservative risk management and long term thinking. The best example of this culture is Wells Fargo's experience during the Global Financial Crisis.

Going into the financial crisis, Wells Fargo was a California-headquartered bank with an overwhelming focus on the western United States. Despite its very strong presence in many of the markets with the craziest credit behavior and the biggest resulting fallout (think California, Arizona, Nevada) and despite its heavy mortgage exposure, Wells Fargo's more conservative credit culture and structurally advantaged funding cost enabled it to remain solidly profitable throughout the Global Financial Crisis. Moreover, because of Wells Fargo's strong financial position and long term thinking, it actually used the crisis to strengthen its long term competitive advantages by acquiring the largely east coast bank Wachovia at a fire sale price when it was experiencing financial distress as a result of its poor credit underwriting in the mortgage market. This acquisition gave Wells Fargo a national footprint and enabled it to consolidate its position in a number of product categories and markets, which has led to an even lower funding cost, more cross-selling opportunities, and more risk reduction as Wells Fargo's exposure to any single geography is now lower.

Now that we've established the attractiveness of Wells Fargo's business, how should we think about the return on investment from purchasing Wells Fargo's stock? Currently the stock trades at roughly 1.8x tangible book. It's projected to earn a 14.5% return on its tangible equity (ROTE) over the next year. If it continues to earn this return indefinitely, then we believe Wells Fargo has the potential to achieve a forward rate of return of roughly 10.5% per year.

However, with interest rates as low as they are, much of Wells Fargo's funding cost advantage is latent. As we discussed earlier, in a normal interest rate environment, Wells Fargo can borrow money from depositors at below the risk-free rate and then lend it out at the risk-free rate plus a small premium, earning it a big net interest margin. However, now that the short-term risk-free rate has dropped to basically zero, Wells Fargo has to invest at much lower rates but it can't lower the interest rate it pays its depositors by the same amount since to pay depositors less than the risk-free rate would mean paying them less than zero percent. And that only works if you're a government in Northern Europe! So, if interest rates rise, Wells Fargo will be able to earn a much wider net interest margin. If interest rates rise and if Wells Fargo is able to achieve a net interest margin of 4% versus its average net interest margin of 4.5% from 2006 to 2011 and its current rate of 2.9%, we estimate that the company would earn an 18% return on tangible equity, still well below the 23% ROTE it earned in 2006 and 2007. If this were to occur by 2023 and if Wells Fargo were able to earn this rate on average in subsequent cycles, then we estimate that the company has the potential to achieve a forward rate of return of roughly 12% per year.

Thus, in a base case, we believe we have the potential for an attractive return, and, in a case in which interest rates go up faster than expected, we believe we have the potential for an excellent return, which is a highly valuable dynamic given the composition of the rest of our portfolio. Since many of the businesses in our portfolio have such consistent cash flows, they, along with almost every other asset class, will experience some pressure on their earnings multiples in rising interest rate environments as the discount rate people use to value them goes up. Wells Fargo, along with our large holding in Schwab, thus serves as a great interest rate hedge for the rest of the portfolio.

Of course, a critical question any good investor will always consider is, "What's the downside?" Given the amount of coverage the media devotes to the topic, one might reasonably surmise that low oil prices are the biggest problem facing the banks and the economy today. We would disagree with this assessment. Wells Fargo's exposure to energy loans is so small that every one of them could go bad, and yet the company would still be profitable. Additionally, low oil prices should actually *improve* long term economic growth because energy is required to build factories, to grow crops, to heat homes, to power automobiles, and, for that matter, to engage in almost any activity. We therefore don't believe low oil prices will materially affect our long term return in Wells Fargo.

On the other hand, if the United States were to go through a crisis of the same or greater severity as the Global Financial Crisis, then the return on our investment in Wells Fargo could be significantly worse than we anticipate. However, as we stated before, we think there is a strong tendency for investors and commentators to overestimate the probability of rare events that have recently occurred and are emotionally salient, and we believe the Global Financial Crisis is a case in point. Additionally, while this overestimation shows up even when the probability of an event remains constant over time, we believe the effect could be even greater in cases where the probability can change based on society's reaction to the event. As a result of the Global Financial Crisis, the U.S. banking system has become much less levered, much more liquid, and much more constrained in its ability to make risky bets. Additionally, the U.S. consumer's balance sheet is in its best shape in decades,[2] home prices (the U.S. consumer's largest asset) bottomed in 2012 and have been steadily rising ever since,[3] and corporate balance sheets are healthy.[4] While the government has certainly taken on more debt, many countries with far less diversity of industry and strength of innovation have a great deal more debt relative to their Gross Domestic Product yet have still avoided the dire outcomes prophesied by the financial cognoscenti, and, unlike the U.S., they aren't in the incredibly advantageous position of being the world's reserve currency. Lastly, because of Wells Fargo's funding cost advantage, conservative risk management, long term focus, and systemic importance to the banking system, we believe the company is likely not only to survive future severe downturns but to thrive by using these tough periods as opportunities to grow their customer base, geographic footprint, and product offering.

In conclusion, we are thrilled to have recently had the opportunity to increase our position in Wells Fargo's wonderful business franchise, and we hope to achieve favorable risk-adjusted returns in the vast majority of future economic scenarios.

Concluding Remarks

Great investing requires the ability to value businesses, to understand why and when they get mispriced, and to assemble a portfolio of these mispriced businesses that is robust to a variety of economic scenarios. We believe we own a portfolio of stocks that meets these objectives. Most of our portfolio is in solid, market-leading, conservatively leveraged businesses, the vast majority of which produce large amounts of cash flow in both good times and bad. We believe most of these businesses are likely to give us superior risk-adjusted returns because they are too boring for the average investor, who is generally impatient, avaricious, and overconfident and thus attracted to more speculative stocks that promise the false allure of the quick score. Additionally, we have supplemented this strong

---

[2] See https://research.stlouisfed.org/fred2/series/HNONWPDPI and https://research.stlouisfed.org/fred2/series/FODSP
[3] See http://www.zillow.com/home-values/
[4] See http://blogs.reuters.com/breakingviews/2015/12/28/balance-sheets-will-get-more-unbalanced-in-2016/

foundation with a few competitively advantaged cyclical companies such as Schwab, Richemont, and Well Fargo that should generate higher forward returns than the rest of the portfolio. Even better, some of these stocks also serve as a hedge on our portfolio if the current expectation of low interest rates persisting indefinitely proves incorrect.

We thank you for your trust and loyalty. Please don't hesitate to call us if you have any questions or concerns. We appreciate the opportunity to serve you in any way we can.

Sincerely,

The YCG Team

Disclaimer: *All S&P data is provided "as is". In no event, shall S&P, its affiliates or any S&P data provider have any liability of any kind in connection with the S&P data. No further distribution or dissemination of the S&P data is permitted without S&P's prior express written consent. The specific securities identified and discussed should not be considered a recommendation to purchase or sell any particular security. Rather, this commentary is presented solely for the purpose of illustrating YCG's investment approach. These commentaries contain our views and opinions at the time such commentaries were written and are subject to change thereafter. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. These commentaries may include "forward looking statements" which may or may not be accurate in the long-term. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable.* ***Past performance is no guarantee of future results.***