Robotti
Value Investors

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Dear Client,

A Year in Review: Critical Economic Overlay

Over the years, we have often revisited an observation by German-born MIT economist Rudiger Dornbusch, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." Within this simple statement lies an important implication for investors: markets are not always efficient. Economic realities evolve gradually, but markets frequently ignore those changes for extended periods of time, until suddenly they do not.

This gap between evolving fundamentals and market recognition is where we tend to focus our efforts. We are often looking for economic situations marked by periods of change, development or especially cyclical recoveries that have yet to be reflected in security prices. In many cases, investors acknowledge that earnings power or asset values are meaningfully higher but remain unwilling to act because the timing of the outcome, no matter how certain, remains elusive. The pervasive *won't get fooled again mentality* creates opportunity for those willing to underwrite the market cycle rather than the next calendar quarter.

This pattern continually repeats itself and over time, has been seared into investor thinking, leading many industries to be labeled as "bad businesses" to be avoided, particularly when conditions begin to improve. The prevailing assumption is that any recovery will be short-lived and inevitably followed by another downturn.

Our view has been different. We believe recurring patterns trigger an economic response. Prolonged downturns force consolidation and often only a small number of well-capitalized operators survive. Many times, this process completely reshapes an industry. Excess capacity is removed, capital discipline improves, and earnings become more durable across the cycle. What were once chronically oversupplied markets increasingly resemble structurally tighter ones. We note, recurring cyclicality can and does often lead to structural changes. Years of underinvestment have shifted many of these businesses from a state of persistent excess supply to one of recurring scarcity.

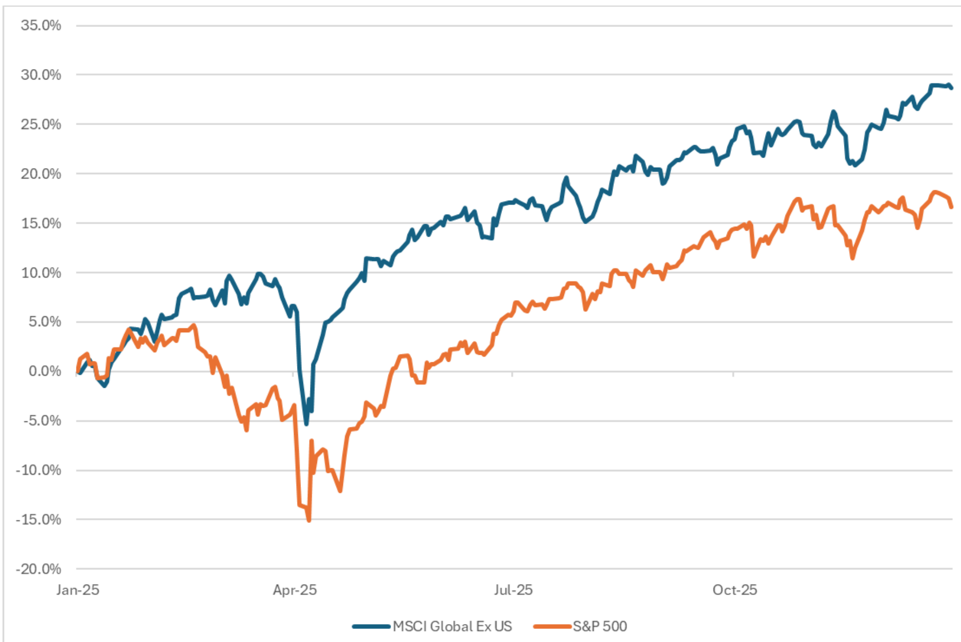
If these supply responses also coincide with demand growth, you can get a powerful secular change. We have noted the macro positioning for Americas industrial renaissance set up by the vast availability of low cost energy in the form of natural gas pricing far below the remaining developed world which is providing persistent economic advantage and incentive as a demand driver. Adding to the positive outlook, we now have the recent evolution of the technology sector. Digital progress has placed growing demands on the physical world, from incremental power generation to the infrastructure required, (with all the attendant demands for materials) to deliver on technology's promise.

At the same time, secular changes have raised barriers to entry and constrained future supply, even as demand has continued to grow.

Observations for 2025

2025 was a particularly affirming year for Dornbusch's theorem. The year featured a number of market developments that, not long ago, were widely dismissed as improbable or even impossible.

Consider just a few examples. Reversing a multi-year trend since the global financial crisis, market leadership has broadened geographically. Equity markets outside the United States materially outperformed U.S. markets over the course of the year. The MSCI World, ex-USA, was up approximately 31.9%, beating the S&P 500 total return of 17.4%, This was particularly notable given how deeply entrenched beliefs in American exceptionalism had become (and still are). For example, Japan, long viewed as a market where capital went to die, experienced a meaningful revaluation. The Nikkie 225 was up 26.2% in 2025 and is up approximately 100% over the last 3 years. Europe also saw renewed investor interest, with European banks standing out as strong performers. The STOXX European Banks Index surged 67% in 2025, its strongest year since 1987. Years of post-financial crisis restructurings led to improved, and eventually, well-capitalized balance sheets. As interest rates *finally* began to rise, cash started flowing back into the banks providing management with the flexibility to execute initiatives, including repurchasing their own shares, and demonstrate their true earnings potential to the market. This prompted the reassessment of a sector many had written off as structurally broken.



Source: CapitalIQ

One of the most notable developments of the year was the continued rise in the price of gold. While the U.S. dollar is enshrined as the world's primary reserve currency, the United States has increasingly used that position as a tool of economic and political leverage. The expanded use of sanctions, restrictions on capital flows, and access to the financial system has led some sovereigns and institutions to seek some safe allocation. That shift has contributed to a renewed interest in gold as a politically neutral store of value. Additionally, there has been growing demand for non-fiat or non-sovereign monetary assets, initially accounting for the creation of bitcoin, with the hopes of it being a stable currency versus the possible depreciation in the U.S. dollar and its debts. (Of course, it turned out even better for bitcoin holders to NOT be a stable currency but much better, a widely appreciated asset). In any case, persistent inflation concerns and rising realism about the impossibility of long-term fiscal discipline across the globe, is also driving increased interest in an allocation to protect against the possible economic risks and market responses.

Events surrounding each of these asset classes reflect Dornbusch's insight in action. In each case, underlying fundamentals had been changing for some time but were largely ignored by the markets. The markets did not gradually adjust as these changes were happening. Instead, when a tipping point was reached, the market adjustment was swift

The encouraging news is that there are other similar opportunities that we were able to take advantage of (housing, offshore, data storage), and more importantly we believe we are invested in companies and industries that exhibit many of the same characteristics today: misunderstood fundamentals, improving economics, and narratives that lag reality.

It is easy to be distracted by whatever the market is celebrating at the moment, particularly when success stories feel close at hand, but our work has never been about chasing trends or immediate gratification. It is about sticking with what we know and applying it consistently through cycles to capture identifiable opportunities.

Mr. Market's Focus on the Wrong Metrics - Abandoning Security Analysis

We have repeatedly highlighted that today's market structure, dominated by passive capital flows, algorithms, and narrative-driven positioning, tends to accelerate these moves in both directions. As a result, competent, experienced stock pickers analyzing individual securities and investing in publicly traded fractional shares of businesses are well positioned to provide strong risk-adjusted returns. Years of capital allocation to segments of the market which have provided strong results has led to the concentration of capital in few, crowded asset classes, all while sucking capital out of the historic underperformers – *everything else*! We observe that the concept of asset allocation has become a process of asset concentration in *the few* leaving *the many* positioned and priced for strong returns to those still focused on fundamental security analysis.

We see this regularly. A single policy-related comment can produce dramatic price reactions, even when the ultimate economic impact is uncertain or marginal. Recently, Donald Trump suggested that Fannie Mae and Freddie Mac could be required to purchase additional mortgage-backed securities, which sparked sharp, immediate reactions across housing related equities. Home builders rallied strongly in a single session, with companies like Builders FirstSource surging, and Home Depot adding tens of billions of dollars in market value in a single day. It is difficult to argue that these businesses suddenly became materially more valuable overnight. Rather, capital overreacted and moved quickly in response to the narrative.

In recent years, we experienced this firsthand during the rapid repricing in the offshore energy sector, when stocks such as Tidewater moved from deeply discounted levels to reflecting a large portion of expected earnings growth in a matter of months. The rapidity of the move surprised many, but the groundwork had been laid by years of underinvestment and consolidation.

Capital flows overshoot in both directions. When an industry is left for dead, capital flees even more aggressively. When sentiment shifts, that capital often rushes back just as forcefully. We spend our time in those abandoned corners of the market, where scarcity of capital has already begun to drive consolidation, cost discipline, and balance sheet repair.

Over time, perception and reality diverge. Entire industries are labeled as permanently broken even as demand improves, competition rationalizes, and earnings power strengthens. The gap between narrative and reality is where we regularly find opportunity.

Long Runways, Not Straight Runways: Mr. Market Overshooting

Through our experience investing in cyclical businesses emerging from prolonged downturns, we have learned that recoveries are rarely, if ever, linear. While the ultimate destination and direction of travel are often reasonably predictable, the path is almost always uneven. Recoveries are idiosyncratic, punctuated by delays, drawdowns, and periods of renewed skepticism. This reality is precisely why our process requires patient capital.

Recently, a family office asked why many investors appear to pursue similar strategies to ours, but achieve very different outcomes. Our view is that the difference is rarely insight alone. More often, it is patience. Persisting through inevitable pullbacks, made possible only by aligned, long-term capital, is what allows fundamentals to ultimately assert themselves.

There is no better historical template for this than our investments in building products distribution tied to homebuilders following the 2009 housing collapse. That prolonged and severe downturn forced deep structural changes across the industry. Capacity was rationalized, balance sheets were repaired, weaker competitors exited, and well-managed players executed significant M&A. The recovery that followed was anything but smooth though. Even in the strongest operators, share prices experienced multiple significant drawdowns along the way. Builders FirstSource, despite being one of the ultimate winners, retraced nearly 50 percent from interim highs on several occasions. Those pullbacks were not signs of failure, but part of the process. We observe similar dynamics at work today.

Offshore energy services provide a current example of this non-linear runway. Following a prolonged downturn after the last commodity cycle, offshore oil service companies were widely viewed as uninvestable. Years of underinvestment, restructuring, and bankruptcies dramatically reduced capacity and forced the surviving companies to rebuild with far more conservative balance sheets. What appeared to be an industry in terminal decline was, in reality, an industry being reset.

Between 2020 and 2024, offshore services began to recover as the consequences of that reset became clear. The extended downturn permanently removed a meaningful portion of global supply. Rightsizing and operational discipline drove substantial efficiency gains, making many offshore projects economic even at oil prices well below recent levels. Notably, this has persisted even as Brent prices have fallen roughly 25 percent over the past year.

The result has been a sharp tightening in the supply-demand balance. Companies such as Tidewater and offshore drillers that emerged from restructuring with improved balance sheets were positioned to benefit disproportionately. With consolidated fleets, restored capital discipline, and replacement costs far above asset values, pricing power returned to a sector long characterized by extreme cyclicality. Equity prices responded accordingly.

This recovery has not been linear, nor do we believe it is complete. Activity today is not being driven by speculative enthusiasm, but by the economic necessity of offsetting natural production declines and replacing existing supply. That reality is increasingly reflected in capital allocation decisions by major oil companies, particularly European producers that had earlier redirected investment toward renewables and are now reemphasizing conventional energy amid growing concerns around supply security.

Investor behavior, by contrast, has been far less disciplined. The sector was enthusiastically embraced in 2023 and early 2024, then abruptly abandoned in the second half of 2024 as concerns around cyclicality resurfaced. That capitulation stood in sharp contrast to fundamentals, which remained intact, with pricing merely pausing at levels still insufficient to incentivize new supply.

The volatility in Tidewater's share price highlights the exaggerations created by modern fund flows and what Benjamin Graham described as the manic-depressive behavior of Mr. Market. We reduced exposure as the stock surged above $100, while the company itself aggressively repurchased shares at an average price near $39 in early 2025. We appreciate the opportunity these manic swings provide.

Throughout this period, Tidewater has continued to generate double-digit free cash flow yields and reinvest that capital to increase per-share value. As industry activity continues to build against a constrained supply base, we believe earnings will reaccelerate and market perception will once again be forced to adjust. As we noted earlier, the direction of travel remains intact, and the ultimate destination, in our view, is meaningfully higher.

Conclusion

Each of these examples reflects a broader and recurring pattern of businesses and industries that fall out of favor enduring a cathartic period before emerging stronger, more disciplined, and structurally improved. This dynamic is not unique to 2025. As long-tailed opportunities continue to develop, we intend to remain positioned to capitalize on them as fundamentals evolve and perception eventually follows, despite the interim market vagaries.

Today's investment landscape remains characterized by the prolonged success of a relatively narrow set of sectors that have delivered exceptional historical results. The concentration of capital into these perceived winners is well documented. Over time, such flows tend to create valuation extremes elsewhere, often in areas where capital has been slow to return despite improving fundamentals. We believe this delayed recognition is not an anomaly, but part of a repeatable pattern, and one that may signal the early stages of a broader rotation in market leadership.

The likelihood of new winners in a world quickly and profoundly changing makes the dispersion of investment performance the logical outcome. This reinforces our belief in the importance of disciplined, fundamental research and patience.

We want to thank you for your continued trust, particularly during periods when patience is tested and narratives move faster (or slower) than fundamentals. Our approach requires shared conviction and a willingness to let time do part of the work. We remain committed to staying disciplined, curious, and aligned with your long-term interests.

As always, we appreciate the relationship we have with you and look forward to the years ahead.

All the best,

Bob

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