Linden Rose Investment

Third Quarter 2017

Letter to LRI Clients

Dear Partners:

For the third quarter of 2017, the return for the Linden Rose Investment ('LRI') Portfolio was 6.29% on a consolidated basis versus 4.48% for the S&P 500 index. For the 9 months of 2017, LRI's return was 39.40% versus 14.24% for the S&P 500 index, which represents a relative performance of 25.16% above the S&P. Due to different timings of deposits/withdrawals and the timing of investment decisions, some accounts were up more than 6.29% in the third quarter, and some less than that. In the long run, we believe the performance of all client portfolios will converge. We would like to remind our investors again that this kind of relative performance may not be sustainable. Past performance is not a guarantee of future performance and we may have some quarters with flat or negative relative performance. We would like our investors to maintain realistic expectations.

Quarterly Return

Quarter	LRI	S&P 500 Index
Q1 2017	15.94%	6.07%
Q2 2017	13.12%	3.15%
Q3 2017	6.29%	4.48%

Our Investment Strategy

The performance of the portfolio so far this year has been so profitable that some friends may wonder how we achieved this level of performance. They might think that we just sit in front of screens all day and trade stocks. However, this could not be further from the truth. In reality, we seldom trade stocks. In fact, most clients have almost the exact same portfolio as they did in the beginning of the year.

Let us reiterate our investment strategy:

We are value investors. Our No. 1 rule is to *not lose money.* We are constantly identifying the potential risks of each individual company in our portfolio. We always try to protect the downside first: if we do not lose money, the upside will take care of itself. *We do not short stocks* because the upside is limited to 100% and the downside is unlimited. *We do not use margin either*. Borrowing money is a double-edged sword. Though it can increase profits, it also increases losses and risk. We do not like the idea of losing sleep over a potential margin call. In addition, *we do not use leverage* either since it comes with cost and risk. We are conservative investors.

We rarely put too much time on macroeconomics. This is not because macroeconomics isn't important, but because it is so hard to effectively apply to our decisions. In addition, the impact of macroeconomics on the companies in the portfolio is minimal. We do not put a large emphasis on the general stock market either. This is because we have no clue as to where the stock market might be tomorrow, next month or next year. We are neutral to the stock market. As Benjamin Graham said: "in the short run, the stock market is a voting machine; in the long run, the stock market is a weighing machine." If we can buy great companies at reasonably good prices and our research is reliable, the stock prices will take care of themselves.

Bank of the Ozarks

During the third quarter, we bought and then later sold shares of Bank of the Ozarks (OZRK) for almost the same price. This was not the first time that we had invested in OZRK. In October 2016 we purchased OZRK at around $38 and after a quick rise to $55, we sold out for a 30-40% profit gain in 4 months due to the decrease in margin of safety. Unfortunately we only put 2% of capital into this idea, so the overall gain was relatively minimal.

In 1979, George Gleason, a 25-year-old attorney purchased a controlling interest in Bank of the Ozarks and assumed active management of the bank. Since then, assets have grown from $28 million in 1979 to $20 billion in the second quarter of 2017. The company went public in 1997. The total return since then, with dividends included, is 4,930%. This translates into a 21.5% annual compounded return. We spent several months researching the Company. In 2017, OZRK was ranked the #1 US bank for the 7th years in a row. The Company's efficiency ratio, noninterest expenses divided by net income (the lower the better), was around 34, 2nd lowest among the largest US banks. We liked everything we saw: the CEO, the management team and the corporate culture. During the financial crisis in 2008 and 2009, OZRK made record full year earnings. We concluded OZRK is the best run bank in the United States.

So, why did we sell OZRK?

On July 27, 2017, Dan Thomas, President of the Real Estate Specialties Group ("RESG") subsidiary resigned without notice period. We thought Dan would be the next CEO of the Bank of the Ozarks when George retired, so naturally, this news really surprised us. We asked ourselves: how could something like this happen without us knowing the reason as to why. We went back to check our notes. There was nothing critically wrong with our research work: from the numbers, past history, and our readings, OZRK was still an excellent company. We came to realize that the problem lies with accessibility. We have no access to OZRK's products or employees. All our knowledge about the company came from readings and readings alone have their limits. To deeply understand a company, we need to interact with their products and services. For example, to understand Apple as a company, we can look at its products. We use iPhones, iPads, and its other products in our everyday lives. We can visit its stores and interact with the Company face to face. We know almost everything happening publicly in the Company. How could we gain that same depth of knowledge about OZRK? We had to be brutally honest to ourselves: we couldn't. Since we do not have the same deep knowledge about OZRK as other companies in our portfolio, why would we continue to hold OZRK in our portfolio?

Therefore, we came to the decision to get out of OZRK even though we still think OZRK is the best bank in the US. We wish OZRK good luck.

Make Friends Among The Eminent Dead

Investing is simple but not easy. We must keep improving ourselves and adapt to the fast and ever changing world. Charlie Munger recommended making friends among the eminent dead. So we followed his advice all the way back to 2,500 years ago: Laozi. What have we learned so far?

(1) The best way to learn is not just remembering a few facts and gaining a little knowledge. The better way is to change ourselves, to align ourselves with nature. We must keep improving ourselves and apply this lesson in real life so that knowledge and action are unified.

(2) Wisdom cannot be gained by pure readings alone. Anything that can be expressed in words is not real wisdom. e.g. how do you explain to a fish what life on land is like? To gain real knowledge, we must experience, ponder and reflect it to get close to the truth.

(3) Wisdom is seldom gained and surprisingly, not many people are willing to get it. So many people follow Warren Buffett, yet only a few really practice value investing. Most value fund managers begin their investor's letters with "we are long-term value investors", then start a long essay on macroeconomics, current stock markets, president election cycles and federal reserve rate changes, etc.

(4) It is not learning new things that is difficult, but getting rid of old ideas. As Charlie Munger quoted what Philip Wylie said: “you couldn’t squeeze a dime between what they already know and what they will never learn.” Just like we cannot add water to a full cup, we cannot add new things to a full brain.

(5) Most of our perceptions of the world are not real, but we human beings differentiate black from white, good from bad and use these terms to put labels on everything around us. We are like blind people trying to figure out what an elephant is like by touching different parts of the elephant. We could easily end up in endless disputes and conflicts with others and not realize that we are all wrong. The truth is that nature is just as it is and there is no bad or good, no beautiful or ugly. Good things could easily turn into bad, or bad into good. We should seek the entirety of things, not perfection. Realizing our limitation and staying humble in front of nature is a big step towards more wisdom.

Conclusion

Investing is simple but not easy. A stock is a partial ownership of a public company. Buying a stock is buying the discounted free cash flow of the company. All we try to do is to figure out the future free cash flow of a company. Simple, right? But not easy. It reminds us of the full attendance awards in school. If you want to be the best basketball player, you will soon realize that your chances of being the next Michael Jordan are very low. But full attendance? Theoretically, everybody could get the award by just showing up every day. Simple, right? But how many students received full attendance awards from elementary school all the way to high school? Last year only one student in my neighborhood high school received the award! Not easy. Investing is like that too. Many investors can have excellent returns for a few years, many less have great returns for over 10 years. If we expand the time frame to 60 years, we only see Warren Buffett still there. Investing is like rolling a snowball, all we need to do is to find a long slope with very thick snow on top of it and keep rolling and rolling the ball.

We will keep learning, understanding and applying value investing for our trusted clients. If you have any questions about your accounts, please feel free to contact us. You can either call us at (973) 841-7158 or email us at bing@lindenroseinvestment.com. **If you know any friends who need investment advisory services**, please refer them to us.

Stay hungry, stay foolish!

Thank you very much!

Yours truly,

Binglin Li	Feng Peng
Managing Partner	Managing Partner

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