Quarterly Letter – 2016 Q2

With this letter, we return to our usual Q2 pattern of discussing stocks we sold and exited. Before we do that, let's discuss Performance and Attribution. We'll finish the letter with Fund and Management Company News, including upcoming travel.

Performance

Q2. We gained 4.5% in Q2, ahead of the four global indices we track. The S&P 500 gained 2.5% on a total return basis, while MSCI Emerging Markets (EM) eked out a 0.7% gain, followed by MSCI Frontier Markets (FM) at 0.5%. MSCI EAFE (developed markets, ex-US) lost 1.5%.[1]

Several investors have asked us what impact the United Kingdom's referendum vote to leave the European Union (Brexit) had on our performance. From Friday, June 24, the day after the Brexit vote, through Thursday, June 30, we lost only 0.6%. Through Monday, June 27, we had lost 2.1% post-Brexit, but then we gained back nearly three-quarters of this loss in the remaining three trading days of the quarter.

YTD and ITD. For the year, we are up 3.1%. MSCI EM has risen 6.4% and the S&P 500 is up 3.8%. Conversely, MSCI FM is down 0.5% and MSCI EAFE is off 4.4%. Since our inception, we are up 76% (6.7% compounded annually) while MSCI FM is down 33% (-4.6% compounded annually). Figure 3 in the Statistical Appendix shows returns since inception for all of these indices, while Figure 4 shows our monthly returns since inception.

Attribution

Quarter-ending AUM was $117 million spread across 54 positions in 29 countries. Figure 5 in the Appendix presents a table of our portfolio statistics and our portfolio composition by country.

Figure 6 in the Appendix shows the top and bottom performing countries for Q2 in both dollar and percentage terms and how our performance compared to MSCI's index for the country. All attribution results are before fees and expenses, as those deductions occur at the fund level, rather than the country level.

Vietnam. For the fourth consecutive quarter, our largest country weight, Vietnam was the top dollar contributor to performance, adding $2.8 million, or 21% in Q2. We've made $8.6 million in Vietnam in these four quarters, while the MSCI Vietnam Index has a total return of -7%. We have been net sellers in Vietnam this entire time as valuations of our stocks

[1] Our June monthly comment that we published intraday on June 30 had incorrect Q2 index performance. We inadvertently excluded April results from our Q2 figures, which generally made the Q2 index figures worse than they actually were. For a corrected monthly comment, see: http://www.frontauracapital.com/monthlycomments/Frontaura_Monthly_Comment_2016_06.pdf. In this updated version, we now correctly include April index results in the Q2 figures. Further, as June is now complete, we include June 30 in all monthly, quarterly, and year-to-date index performance figures. Previously, as is our custom, these figures ran only through June 29, as final index values for June 30 were not available at the time of original publication. Our estimates of Frontaura performance were correct in the original comment. We have since fine-tuned commentary around our performance and how our performance relates to the indices.

have risen, and we'll discuss some of those sales later in this letter. We've continued selling Vietnam in July, and we expect its five-year run as our largest country weight likely ended with June 2016. We have thought this before and been wrong, however, as performance pushed Vietnam back to the top.[2]

Other winners and losers. We made $0.8-$0.9 million each in Georgia, Papua New Guinea, and Bangladesh, with percentage gains of 34%, 12%, and 14%, respectively, in those three countries. Significant losers were Montenegro, down $0.7 million, or 15%, and Ghana, down $0.6 million, or 19%. Overall, we made money in 24 countries and lost money in 10 countries in Q2.

Nigeria. Nigeria, 7% of our portfolio at quarter-end, had an eventful quarter with authorities deregulating gas prices in May and devaluing the currency 30% on June 20. We analyzed these events in our May[3] and June[4] monthly comments. We made 7% in Nigeria in April and 33% in May, before losing 30% in June due to the devaluation. For the quarter altogether though, we were flat in Nigeria, as if nothing happened.[5]

With the currency at a more reasonable level, our Nigeria portfolio now looks tantalizingly cheap. At June 30, our trailing Nigeria PE was 4.3 with a 0.3 price/book and a 9.8% weighted average dividend yield. Things are far from perfect in Nigeria, but that's usually true when a country is at these valuation levels. Among other things, we'd like to see the central bank's role in the foreign exchange market diminish, lest the new currency level of 280-285 become a new de facto peg. See our June comment for further analysis.

Figure 7 in the Appendix shows how and why our country mix has changed over the past quarter and year. Figure 8 shows portfolio concentration changes over these periods.

Why We Sell

We devote the bulk of this letter to a review of position exits in the first half of 2016. We'll make some background comments on why we sell, and then we will discuss each sale.

We assign a reason to every stock sale we make. Altogether, we have nine sell reasons, although only seven of these apply when exiting a position completely. Figure 1 shows the dollar-weighted sell reasons for every sell trade from our inception through June 2016. Since we last showed this graph two years ago, only two categories have changed by more than two percentage points. Trim has jumped from 16% to 22%, as last year we actively reduced position sizes to raise cash to meet redemptions. As a rule, trims occur only when rebalancing position sizes, not when exiting positions. Governance dropped from 6% to

---

[2] Vietnam has been our largest country weight from June 2011 through June 2016, with the exception of five months, June 2014 through October 2014, when Nigeria edged it out.

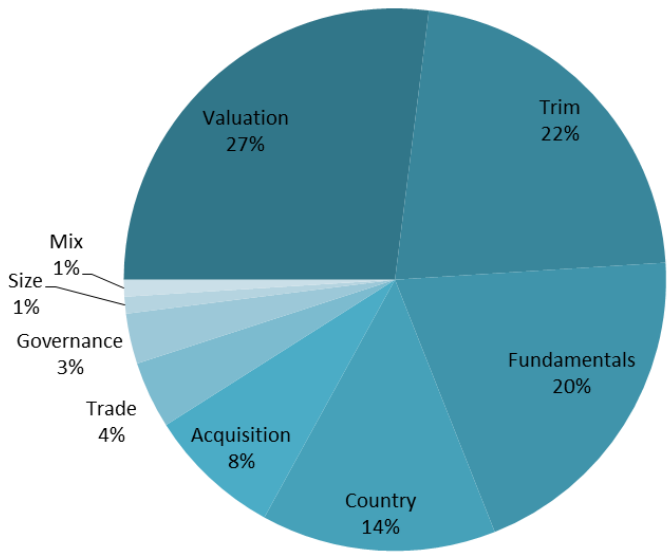
[3] http://www.frontauracapital.com/monthlycomments/Frontaura_Monthly_Comment_2016_05.pdf.

[4] http://www.frontauracapital.com/monthlycomments/Frontaura_Monthly_Comment_2016_06.pdf.

[5] Including the devaluation effect from the time we accrued for dividends to the time we received dividend cash in US dollars, we lost $0.1 million, or 1%, in Nigeria in Q2. Our standard approach to calculating country returns does not include exchange rate changes on cash and accruals in that country, as these changes are typically immaterial and do not fit easily into our calculation framework. We do account for exchange rate changes on stock positions, which can be material. Click this link for an explanation of how we calculate country returns: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.

3%, possibly indicating that frontier company governance is improving, or alternatively that we have become better at avoiding dicey situations where management or the board doesn't act in the best interest of all shareholders. This may just be good luck, however.

Figure 1
Frontaura Global Frontier Fund LLC
Reasons Why We Sell
Inception to Date, Dollar Weighted
30 June 2016



Valuation remains the most common sell reason, at 27% of sales. Fundamentals is now third, behind trim, at 20%. Both valuation and fundamentals sales are due to overvaluation. In the former case, a stock price rising more rapidly than intrinsic value causes the overvaluation. The latter situation is due more to declining intrinsic value because of fundamental underperformance.

The fourth most common sell reason, at 14%, is when the sale results from a country issue rather than a company-specific problem. The other remaining sell reasons are acquisition (8%), trade (4%), size (1%), and mix (1%).[6] Size may appear frequently as a sell reason, but these are small positions that collectively do not add up to much in dollars. Similarly, two loss-making exits in this letter's list have trade as the reason, but trades represent only 4% of our sales since inception.

---

[6] Trade indicates an opportunistic situation such as arbitraging a mispricing when a stock lists on multiple exchanges or a macro play where the sale is not for country-specific reasons. Size is selling a position because we could not accumulate enough of a stock. Mix is our decision to reduce the target weight of a stock due to increased company risk. We distinguish between trim (selling down to an unchanged target weight) and mix (changing the target weight). Both are not complete position exits, so neither will show up as an exit reason in Figure 2.

What We Sold

Figure 2 shows our eight position exits from January 2016 through June 2016. We describe each in chronological order below. This is the fifth letter in which we've listed every stock sold and exited over a defined period, regardless of performance. The first three letters, in Q2 of 2013, 2014, and 2015, discussed exits over the prior 12 months, from the preceding July through the June of that year. In the Q4 2015 letter, we deviated from this pattern, listing sales from July 2015 through December 2015. This letter covers the six months since then, January 2016 through June 2016, putting us back on a Q2 schedule.

Figure 2
Frontaura Global Frontier Fund LLC
Position Exits January 2016 – June 2016[7]
30 June 2016

Company	Country	Description	Exit Reason	First Buy	Last Sell	Cost ($000K)	Proceeds ($000K)	Profit ($000K)	Return Multiple	IRR	Holding Period	Price / IV First	Price / IV Last	PE Buy Date	PE Sell Date
Southern Seed	Vietnam	crop seeds	fundamentals	06-Jun-11	09-Mar-16	261	628	367	2.41	24.2%	4.8	-28%	94%	6.2	16.8
Gubre Fabrikalari	Iran	fertilizer	trade	28-Apr-15	15-Mar-16	1,886	1,455	(431)	0.77	-23.7%	0.9	40%	23%	11.7	21.3
Tavantolgoi	Mongolia	coal mining	fundamentals	25-Sep-13	04-Apr-16	479	217	(262)	0.45	-33.1%	2.5	-56%	-8%	3.3	(81.1)
Oil basket	numerous	oil exploration & production	trade	23-Apr-15	19-Apr-16	8,152	4,199	(3,953)	0.52	-50.9%	1.0	na	na	na	na
Banque pour le Commerce Exterieur du Lao	Laos	bank	fundamentals	26-Oct-11	27-Apr-16	2,966	2,262	(703)	0.76	-10.0%	4.5	-46%	6%	11.1	11.5
Thanh Hoa Beer	Vietnam	brewery	size	18-Nov-15	12-May-16	73	55	(18)	0.75	-28.9%	0.5	2%	-5%	10.3	12.7
Binh Minh Plastics	Vietnam	plastic pipe manufacturing	valuation	31-May-11	23-May-16	1,532	7,069	5,538	4.62	49.1%	5.0	-31%	58%	5.4	14.1
Everpia	Vietnam	bedding products	valuation	07-Jun-11	23-Jun-16	1,134	2,575	1,441	2.27	20.3%	5.0	-35%	101%	4.2	15.1

Our stock picks as represented by our recent sells had mixed results. Five of the eight exits lost money, although collectively we did have a $2.0 million gain. The three winners were all from Vietnam, with the initial investments in these three stocks made within one week of each other in 2011, at trailing PEs ranging from 4 to 6. Our final sales in these three stocks occurred when their PEs ranged from 14 to 17.

In the past, we've always had more winners than losers, often overwhelmingly so. The prior four position exits letters listed 36 winners and only 12 losers combined, although in one year July 2014 through June 2015 we had a collective loss despite 10 winners to 8 losers. Since it's often best to sell your losers and move on, we'd caution not to be too caught up in this kind of scorekeeping. A manager could in theory never show a loss and always show winners by selling stars and retaining dogs.

[7] Here are definitions for the Figure 1 columns. Exit Reason is a standardized reason why we sold a stock, as we explained earlier in this letter. First Buy and Last Sell are the dates we first bought a stock and the day we last sold a stock. Buys subsequent to the first date we show could continue for months or years; likewise, sells could precede the last date we show for months or years. Cost is the USD sum of all buys including commissions, trading fees, and foreign exchange costs (FX). Proceeds are the total USD sale and dividend proceeds, net of all commissions, trading fees, FX, and tax withholding. Profit is the Proceeds minus the Cost. Return Multiple is Proceeds / Cost. IRR is the internal rate of return on all USD cash inflows and outflows in the Profit calculation. Holding Period is the number of years between the First Buy and the Last Sale dates. We annualize the IRR, except for when the Holding Period is less than one year. Note that the Cost, Proceeds, Profit, Return Multiple, and IRR figures are before any management fees, fund expenses, or incentive compensation, as those deductions occur at the fund level and not at the individual stock level. Price / IV First Buy and Price / IV Last Sell show the discount or premium of the closing stock price (not our actual transaction price) relative to our estimate of intrinsic value on the First Buy or Last Sell date. A negative percentage indicates a discount to intrinsic value; a positive percentage indicates a premium. PE Buy Date and PE Sell Date show the trailing reported PE using the closing stock price (not our actual transaction price) on the day of First Buy and Last Sell.

In our discussion below, we often describe what motivated the investment, why we sold, how we sold, and what went right or wrong with the investment. By design, we spend far more time on our losers than our winners, as we think losses provide a greater opportunity for learning.

Southern Seed (Vietnam)

Southern Seed is one of a number of successful Vietnamese holdings we bought in 2011, when few investors, local or domestic, cared about Vietnamese stocks. We made 2.4 times our money in the nearly five years we held Southern Seed, with all of the gains coming in our first three years of ownership. Company profit dropped year-over-year in each of the last four quarters we held the stock, leading to its eventual sale due to poor fundamentals. 2015 EPS actually fell below 2010 EPS, but a jump in PE from 6 to 17 gave us a nice gain anyway. The position was never that big for us—when we began accumulating it, it often traded just above our buy limit. At other times, our purchases were constrained by our 15% Vietnam country limit. Therefore, our profit was limited to $0.4 million.

Gubre Fabrikalari (Iran)

In May 2011, we attended a small dinner in Cambodia and found ourselves seated next to a senior leader of a company listed in Singapore about which we knew nothing. This company's operations were in Myanmar, the country we'd just come from, which made for an interesting dinner conversation. At this time, Myanmar was on no one's radar, as there were not yet any signs of it opening up. Less than a year later, Hillary Clinton had visited Myanmar, everyone was discussing it, and the company we'd never heard of, and did not buy, Yoma Strategic Holdings, was up 9-fold. At its peak, 25 months after our dinner, Yoma was up 17-fold.

Myanmar wasn't the first time we'd been to a place that no one cared about, didn't think to invest there, and were caught napping when the country became a buzzword ten-bagger: Mongolia, from the time of a personal visit in 2005 through its 2011 peak, rose 40-fold.[8] With Iran, we were determined not to let this happen to us again. To reveal the outcome however, Iran was the case where we would have been better off continuing to slumber.

We first visited Iran in 2010 and were impressed with the country's investment potential.[9] Sanctions prevented direct investment in Iranian companies, so as the nuclear agreement was approaching signature last year, we scoured the world for proxy investments. Most ideas brokers tossed around offered only limited exposure to Iran, with most of a suggested company's revenue and profit originating elsewhere. In the end, we found one genuine Iran play accessible to US investors—Turkish listed fertilizer producer Gubre Fabrikalari

---

[8] Before we had the idea for Frontaura, we made a personal non-investing trip to Mongolia in June 2005. "Wow, Ulaanbaatar looks as if communism ended only yesterday," was our summary thought on the then still dilapidated state of the capital city. If, instead of playing tourist, we had read about the country's new mineral finds and bought every stock in the Mongolia Stock Exchange Top 20 Index, we would have enjoyed a 17-fold move from the day we left to the September 2007 peak. Then had we held on through the financial crisis, despite losing most of our earlier gains, we would have recovered everything and went on to record a 40-fold advance (38-fold in dollars) through the February 2011 peak. These figures ignore dividends.

[9] See http://www.frontauracapital.com/observer/Frontaura_Observer_Issue_18.pdf for a thorough review of our 2010 trip.

(Gubretas), whose Iranian subsidiary accounted for 46% of its revenue and 85% of its profit.[10]

We bought Gubretas in April 2015, 11 weeks before the actual Iran nuclear deal agreement on July 14, but four weeks after diplomats announced a deal framework. The chart suggests we missed too much of the Iran run-up as Gubretas had already doubled in the seven months before we bought; however, earnings were good during this period and the stock still traded under 12 times trailing profit when we bought, so it was hard to say whether fundamentals or Iran speculation drove the stock gains. The stock hit its all-time high on 21 July 2015, one week after the nuclear deal conclusion. Come March 2016, however, the stock price was down, and earnings were down even more. With Gubretas now on a 21 PE, it was an easy decision to sell and take the short-term capital loss prior to the one-year anniversary of this trade. We lost $0.4 million or 23%.

Why didn't Iran work like Myanmar and Mongolia? First, we believe Gubretas was too big and too liquid for a 10-bagger outcome to be likely. The company had a $927 million market cap and traded $5 million per day when we invested, so it wasn't small and illiquid like Mongolia's stock market, or like Yoma in 2011. In those cases, waves of new money pushed prices up in a straight line. Second, one could argue that Gubretas did work, as it tripled from its 2014 low to its 2015 high—we just missed too much of this rise and then suffered the post-nuclear deal selloff (buy on the rumor, sell on the news). Although, again, it's impossible to disentangle if the price action was Iran-related or earnings-related. Third, unlike the earlier examples, emerging and frontier markets had fallen out of favor while we held Gubretas, so it may be that there were too few investors looking for Iran proxies. Finally, we think the best way to invest in Iran is to own stocks directly on the Tehran Stock Exchange, where valuations are low. This avenue opened to global investors in mid-January 2016 under sanctions relief, perhaps reducing the relative appeal of Gubretas. Unfortunately, the US government still prohibits US investors like Frontaura from investing directly in Iran, a market that was up 25% in US dollars in the first half of 2016.

Tavantolgoi (Mongolia)

Two decades ago, early in our investing career, a mentor advocated growth-stock investing. The problem with value stocks, he said, is that "You have to be right twice," meaning that you must correctly time both your entry and your exit. Tavantolgoi (TTL) is a value stock example of getting the exit timing wrong.[11]

When we visited Mongolia in 2010, the hype following various large mineral deposit discoveries turned us off. We didn't invest. So far, so good. As often proves to be the

---

[10] Turkey is not in our frontier universe. Gubretas's economic exposure is more Iranian than Turkish, however, so we classified it as an Iranian company. Nevertheless, its headquarters are in Turkey and it lists its stock on the Istanbul exchange, so the US government does not restrict US investors from owning it. In fact, many well-known US fund managers who offer Turkish or emerging market index funds or ETFs own it.

[11] In contrast, our mentor said, with growth stocks you only have to be right once (by selecting a good company with a long runway of growth). We agree that's true when it works, but the academic evidence is clear that value stock investing does better than growth stock investing over time. Using similar wording, we'd say the problem with growth stock investing is three-fold. First, you usually overpay for growth stocks because valuations are high. Second, you have to be right constantly because this high valuation level leaves no margin for error should the fundamentals perform below your expectations. And third, academic research proves that growth is mean reverting, so more likely than not you will get the fundamental disappointment that you need to avoid if the stock is to work.

case, hype leads to hubris, and hubris leads to a fall. Mongolia's politicians, emboldened by global investor attention, and visions of sudden riches, overreached, became greedy, changed investment rules, and quickly turned from investment darling to investment pariah.

When we visited again in September 2013, the buzz had ended, and the local stock exchange index was nearly 60% off its 2011 peak in local currency price terms, or nearly 70% in USD price terms. The second largest locally listed company was a large coal mine, down more than 80% from its peak, trading on a PE below 4, despite earning a 75% return on capital and paying a double-digit dividend yield. Further, a forced seller was offering a large block of stock at a discount. In terms of entry timing, this was about as perfect of a situation as we will ever find. At its December 2013 high, within three months of our buying at a 3.3 PE, TTL had risen 174% from our entry price. Merry Christmas—a great start. It all went wrong from there. The commodities rout of 2014 and 2015 erased all of this gain and left us with a -55% total return in dollars, but equal to only $0.3 million, as this was a small position. The local stock price went down, the currency plummeted, sales of TTL's coking coal to China for steel making fell precipitously, the dividend went away, buyers evaporated, and we had to drive the price down further to generate any buying interest in the stock. If our entry timing was textbook perfection, our exit was a textbook example of a) what can go wrong when you overstay your welcome on a value stock and b) what can happen to a commodity producer in a commodities rout, especially when there is large customer concentration risk to China.

Oil Basket (numerous countries)

For just under one year through April 2016, we had one buy-and-hold, unchanged position in a basket of 20 frontier oil stocks. We lost $4.0 million, or 48%, on our $8.2 million investment. This position initially equaled 5% of our portfolio, and it cost us a 2.5-percentage point hit to overall fund performance. We think the idea had merit in concept, but we flubbed the implementation by not designing risk controls to limit our loss. Given how prices of oil and oil stocks evolved during our holding period, we would have lost money no matter how we implemented the idea, but the loss could have been materially lower. As this is both the largest position we discuss in this letter and the largest loss, we take an in-depth look at this investment. Please see the Appendix for a multi-page discussion.

Banque Pour Le Commerce Exterieur Lao (Laos)

BCEL is the largest commercial bank in Laos, 70% owned by the government. Its market presence, its low price tag, and its high yield attracted us. Being able to buy the largest bank in a country at a total market cap of $128 million, with a 10% yield sounds like an obvious bargain. In the end, it wasn't, as we lost about one-quarter of our investment, or $0.7 million, over 4.5 years. The high yield helped to reduce our stock price losses, as ultimately over one-third of the proceeds we realized from BCEL came in the form of dividends. Nonetheless, a steady reduction in the dividend amount was one of the reasons why we eventually gave up on the stock.

BCEL was one of two companies to come public in the January 2011 debut of the Lao Securities Exchange—an event so well publicized that we totally missed it.[12] This stock

[12] BCEL later traveled to Chicago to meet us in our office, soothing any hurt feelings.

nearly tripled in its first month. We first bought in October 2011, at a level less than half its peak. While BCEL's PE was 11 when we bought, EPS was growing rapidly, up 51% in 2011 and a further 61% in 2012. We initially accumulated up to 1% of the bank's shares, the maximum allowed for any single foreign holder. We met with and petitioned the Lao securities regulator to change their rules so that different legal entities run by the same manager could each own 1%. They welcomed our input and within a few months, they changed their rules, and we doubled our position. Access to decision makers who readily want your input is one of the charming features of frontier markets. A similar change in the US would be nearly impossible, although in this case lack of change would have been more profitable for us.

From the beginning, we saw the negatives of BCEL. High government ownership often means a sleepy bank, with some directed lending, and higher-than-normal non-performing loans. BCEL was consistently undercapitalized, and this situation persisted and worsened because the government either didn't have or didn't want to contribute the cash necessary for its share of a rights offering.[13] Since the government didn't want its ownership stake diluted either, the necessary capital raising never occurred and the bank's leverage continued to increase. We lived with this for a while, reasoning that the government would not allow a failure where it was the majority owner of a systematically important bank that was also symbolically important as one of the first two listed companies on the stock exchange. We still believe this, but eventually we sold. We could no longer stomach the increasing leverage, worsening earnings, and shrinking dividend. EPS growth decelerated to 6% in 2013, before EPS plummeted 44% in 2014 and fell a further 6% in 2015.

Selling was a challenge initially, as we were the largest foreign owner, multiple sellers existed, and few buyers were present. A set of facts such as these usually suggests you've got to get the price down to where the market clears, and that's what we did, selling aggressively at lower prices until we were the only willing seller remaining.

Thanh Hoa Beer (Vietnam)

We never owned much of this brewer as the price ran beyond our limit after we began buying. The company then had two weak quarters, lowering our intrinsic value. We couldn't foresee buying more of the stock in the next year and we owned too little to continue holding. With fundamentals now weak, buying interest disappeared. Our position was too small to bother with trying to optimize our exit price, so we self-inflicted a trading loss as we exited. We lost a quarter of our value in the six months we owned, but this represented only $18,000, reducing fund performance by less than two basis points.

[13] We find simple is best when it comes to measuring leverage. No opaque risk-weighted assets, capital adequacy ratios (CAR), Basel II, or Basel III measures for us. We simply look at the ratio of equity to assets on the balance sheet, something that is transparent and which we can self-calculate for any bank we research, unlike a CAR where we must rely on a bank's internal calculation. When we bought, BCEL had an equity / assets ratio of 7.4%, or 13.5 times levered (1 / 0.074 = 13.5). BCEL was an exception for us as we usually start getting nervous when this ratio is below 10%, but we reasoned that BCEL's large government securities holdings and implicit government backing provided additional protection. By the time we sold, BCEL's equity to assets ratio was only 4.4%, or 23.0 times levered. Note that the equity / assets ratio, which we colloquially call the Basel 0 ratio, will be much lower than the capital adequacy ratio (CAR). For example in the first quarter of 2008, UBS reported a Basel II CAR of 10.7% and an equity / assets ratio of 0.73%, meaning its assets were leveraged 137 times over its equity base. We submit that our simplistic Basel 0 ratio was a truer indicator of UBS's health than the more sophisticated CAR measure.

Binh Minh Plastics (Vietnam)

Like Southern Seed, Binh Minh Plastics (BMP) is another success story from our Vietnam 2011 vintage. BMP is the leading manufacturer of plastic pipes for infrastructure and real estate construction uses in South Vietnam. We paid 5 times earnings, and exited five years later, selling at up to 16 times a higher earnings base. We made $5.5 million, 4.6 times our money, for a 49% annual IRR. This one big winner more than offset the five losers we sold.

Other exits in this letter describe how we had to drive the price down to get out of a stock; BMP represented the opposite side of a liquidity imbalance—we often received a premium to the market when selling it, as we owned a large amount of a stock that investors now covet. We did most of our final selling of BMP in March 2016, with our last sale of the month 14% above our first sale of the month, despite the VNINDEX being flat for the month.

Everpia (Vietnam)

Everpia makes mattresses, comforters, and related bedding products. Unlike Southern Seed where our gains came early, Everpia was a stock that never looked like it would work, but eventually did in the end. We made 2.3 times our cost over five years, earning a $1.4 million profit and a 20% IRR. In dollar terms, the company's 2010 and 2015 earnings were similar, yet the PE rose to 15 when we last sold versus 4 when we first bought, reflecting a 180-degree change in investor sentiment on Vietnam.

From our first buy in June 2011 through the end of 2011, we lost over half of our investment. In our experience, it is rare to come back from that kind of loss, as you need more than a double just to get back to break-even. Nevertheless, when 2012 began, Everpia's trailing PE was only 2.5 and our intrinsic value framework ranked it as the most undervalued stock we owned. This low valuation led to performance gains such that we were back to break-even by the end of that year, before shooting into the black in 2013. Unfortunately, by late August 2015, we were under break-even again. Then, from that point to where we last sold Everpia about ten months later, it tripled on a total return basis, as it recovered from an earnings slump, and as foreign investors' infatuation with Vietnam grew. We tout Everpia as an excellent example of how difficult it is to predict stock performance. The stock often refused to advance when we thought it obviously undervalued, but eventually it astounded us by rising more rapidly than we expected.

Fund and Management Company News

Please e-mail us if you are interested in an end-of-quarter phone call or visit.

Open for investment. We remain open for investment, accepting new investments monthly. We invest money received on or before the last business day of each month on the first day of the following month. For example, we will invest funds we receive on or before Friday, July 29 as of August 1. We will invest funds we receive on or before Wednesday, August 31 as of September 1, and so on. For new investors, our minimum is $1 million; for existing investors, the minimum follow-on investment is $10,000. There is no additional paperwork for follow-on investments.

Travel. In April, we attended an investment conference in New York, where we met 25 companies from 17 different countries. We also visited clients and prospects in New York. We attended a timely investment conference in Nigeria, seeing a dozen companies over two days. Please see our May comment for a discussion.[14] Nick will again be in New York to meet investors on Monday, July 25. We will also be in London during the first week of September for an investment conference.

In the Appendix that begins on the next page, we discuss our frontier oil stock position exit in depth. Our usual Statistical Appendix follows that. Please e-mail or call us if you have anything to discuss. We thank you for being a Frontaura client.

Best regards,

Nick Padgett, CFA and Stephen Mack
Managing Directors, Frontaura Capital LLC
Two Prudential Plaza, 180 North Stetson Avenue, Suite 1935
Chicago, Illinois 60601 USA
Phone: +1 312 777 1500 Fax: +1 312 268 5004 info@frontauracapital.com

[14] http://www.frontauracapital.com/monthlycomments/Frontaura_Monthly_Comment_2016_05.pdf

Appendix
Frontier Oil Basket

Background

In our April 2015 monthly comment,[15] we made two observations. First, the oil price had fallen over 50% from its peak, but then rallied 30% from its low. Second, looking at the last five times that oil fell 50% or more, then rallied 30% or more (1985-1986, 1990-1991, 1997-1998, 2000-2001, and 2008), in every case, the low in the oil price had either been reached, or was very close. One year after the date on which the 30% rally occurred, oil was a further 40% higher on average. That's another 40% beyond the initial 30+% rally, and this even includes cases where the initial rally sputtered out and a new low occurred.[16] While we couldn't be sure that oil had bottomed, we did think that at worst, it was not far away, and more likely than not, oil would be higher in one year's time. Beyond what we wrote in the comment, we had two further observations. First, many developed world oil companies had rallied along with the oil price to a greater degree than had many frontier market oil companies. Second, at past global market turning points, frontier stocks often lag their developed and emerging counterparts, before later catching up.

From these observations, we posited that a global basket of frontier oil stocks represented above average risk/reward in April 2015.[17] We invested $0.4 million each in a basket of 20 frontier companies involved in oil exploration and production or oil services. These 20 companies represented 14 countries, comprising a 5% portfolio position at the time we initiated the trade. In our April 2015 comment, we offered plenty of caveats about every episode of history being different, our study only encompassing five prior data points, and our study result probably not being a good single point predictor of what would happen this time. Nevertheless, we felt the weight of evidence was directionally clear, and our oil basket was a reasonable trade even if ultimately it did not work.

---

[15] http://www.frontauracapital.com/monthlycomments/Frontaura_Monthly_Comment_2015_04.pdf

[16] The actual outcome this time is that oil was 30% lower one year after its initial 30% rally. Now over six episodes, including the 2014-2016 price break, oil is up an average of 28% one year (or 20% on a compounded basis) after the initial 30% rally. We note that the -30% outcome this occurrence is similar to the 1990-1991 Gulf War outcome where oil was -26% one year after its first 30% rally. What is different this time from the Gulf War is that energy stocks fell significantly along with the oil price. In contrast, after the Gulf War, energy stocks were flattish in the year afterward, even though the oil price fell. With the Gulf War end, the oil price fall occurred for a bullish reason—the reduction of a global geopolitical risk—whereas this time the oil price fall was bearish, a sign of economic weakness and reduced capital spending.

[17] The actual inspiration for the design of our trade came from the famous global investor John Templeton. In 1939, he purchased a basket of 104 US stocks trading for below $1, reasoning that the war in Europe would increase US economic activity and improve the fortunes of these beaten-up companies. He did little company analysis before initiating this trade—his thinking was top down, not bottom up—thus, he didn't try to predict which companies would recover best. He bought a basket of low quality names that gave him broad exposure to high beta stocks. Templeton made a four-fold gain, holding each stock on average for four years. The parallel we saw was that the market had beaten up oil stocks, but history suggested an oil price recovery was likely. We didn't know which oil companies would recover the most, so we too invested in a diverse basket of 20 companies from 14 countries. For a discussion of Templeton's trade, see chapter 2 of *Investing the Templeton Way* by Lauren Templeton and Scott Phillips, published by McGraw Hill in 2008.

Our intent was to hold a basket for around one year, meaning a bit more than a year if the idea was profitable (to obtain a preferable long-term capital gain tax rate for our taxable clients), or a bit less than a year if the idea was losing money (to take a short-term capital loss).

While an infinite number of outcomes existed, conceptually, we thought in terms of three possible scenarios: optimistic, neutral, and pessimistic. In stylized terms, we observed that a typical frontier oil stock had peaked at 100, dropped to 40, and rallied to 50. We thought the most likely outcome, with a 50% probability, was that of a further rally to say 75—that is a gain of 50% from our buy point, but still well below its prior high. We thought it was just as likely that our idea did not make money, with a 25% chance we broke even (our stylized stock price stayed at 50) and a 25% chance our stylized stock price dropped back to its low of 40 (a 20% drop). Multiplying our probabilities by our expected returns (0.5 * 0.5 + 0.25 * 0 + 0.25 * -0.20) gave us a weighted average expected return of 20%. Of course, this was all conjecture on our part, but it illustrates our thinking prior to the trade. In fact, we lost 48% on our oil basket, a $4.0 million hit.

Outcome

What happened? Obviously, we got a pessimistic outcome much more negative than our -20% scenario. Let's look at what the oil price itself did. The 30% rally in the US WTI crude price[18] occurred on 16 April 2015 at $56.71, up from a low of $43.46 on 17 March 2015. The March 2015 low did not hold; the oil price hit a new low of $38.09 on 24 August 2015. This is not unusual; it has now happened three times out of the six occurrences in the past 30 years when oil has suffered a 50% drop. Oil rallied 30% for a second time when it hit $49.63 on 9 October 2015. This second low didn't hold either, and that is unusual. In the five prior 50% selloffs, the initial low held three times and the second low held twice. A third low occurred only in this most recent case. That low was $26.21 on 11 February 2016. A 30% rally from that level occurred on 1 March 2016 at $34.40. On 8 June 2016, oil reached its recent high of $51.23, 95% above the February 2016 low.

At the low point on 20 January 2016, we lost $4.9 million, or 60% on this trade. The total hit to portfolio performance was 3.3 percentage points. We began our liquidation on March 22, after oil rallied 50% from its February 11 low. We sold the 20 companies gradually over the course of four weeks, with our last sale occurring on 19 April 2016, a few days before the trade's one-year anniversary. Oil was $41.08 that day. Our final loss was under $4.0 million. We gained nearly $1.0 million from our low point, boosting portfolio performance by 0.8 percentage points. Should we have continued the trade? We were happy to have had the 50+% rally and thought it best to stick to our original timeframe, as we had no conviction near-term as to whether the rally would continue or partially retrace.

Risk Management

How could we have structured this trade better? Most of our investments rely on an intrinsic value framework that gives us an innate sense of when to buy and sell. In this

[18] Throughout this letter, we use the US West Texas Intermediate (US WTI) Cushing crude oil spot price (USCRWTIC Index on Bloomberg). While the Brent oil price is more relevant for frontier stocks, we use the US WTI price because it has a longer data series on Bloomberg that allows us to look at all five 50% oil price drops over the past three decades. The difference between these two references prices is small at present. We reference the closing price on all dates we cite.

case, intrinsic value was highly dependent on a volatile, global commodity price that—in the short-term at least—is nearly impossible for even experts to forecast accurately. We think in hindsight, then, bereft of our intrinsic value framework, we should have employed risk management techniques to exit the trade if events suggested that our original thesis was invalid. In the interest of self-improvement and learning, here are some after-the-fact ideas we have.

1. **If the oil price breached its initial low by a greater percentage than had occurred before, we could have ended the trade.[19]** For example, in both 1991 and 1998, the original oil price low did not hold. In 1991, the ultimate low was 9% below the original low; in 1998, the ultimate low was 7% lower. We could have ended the trade if the oil price fell more than 9% (the level of the 1991 breach) below the original oil low of $43.46. That did occur, on 24 August 2015 with a closing price of $38.09, 12% below the original low. Had we begun liquidating then, we estimate that at worst we would have lost $3.0 million on the oil basket with a total portfolio hit of 1.9 percentage points.[20] This is somewhat better than our actual outcome of a $4.0 million loss and a 2.5 percentage point hit.

2. **If the oil price breached its second low, we could have ended the trade.** This occurred on 7 December 2015, when the price broke below the 24 August 2015 low. In none of the five earlier 50% oil price drops, was a second low breached, so this signaled that this episode was different from the prior five oil price drops. We did think about ending the trade in December, but not having this rule in place ahead of time kept us from acting. At the time, the trading behavior in oil and oil stocks reminded us of other year-end capitulations, often driven by year-end tax-loss selling. Having observed many such year-end capitulations reverse into sharp rallies when the calendar year changed, we were reluctant to abandon our trade before its one-year completion. If we'd had this mechanical rule, however, we would have exited then. In this case, our outcome would have been only slightly better than our actual result. We estimate we would have lost up to $3.9 million with a similar 2.5-percentage-point hit to the portfolio.[21]

3. **We could have defined upfront the maximum amount we were willing to lose on the trade, and ended the trade when oil hit that threshold.** For example, using our three scenarios, we could have decided upfront that if performance fell below our pessimistic scenario (down 20%), we'd sell everything.

[19] For clarity, what we call a low can only occur in hindsight after the oil price rallies 30%. Thus, a second low requires a) a 30% rally from the initial low b) a fall to a price below the initial low and c) a 30% rally from the second low.

[20] On 24 August 2015, we'd lost $3.0 million cumulatively on the basket, a total portfolio performance hit of 1.9 percentage points. By 31 August 2015, this improved to a $2.4 million cumulative loss and a 1.5-percentage-point hit. Most of our sales would have been front-end loaded during this one-week interval when oil stocks rose rapidly. Allowing for market impact and transactions costs, we believe the worst we would have done would be to realize the 24 August prices. We may have finished somewhat better than this.

[21] On 7 December 2015, our cumulative oil basket loss was $3.7 million with a 2.3-percentage-point performance hit to the portfolio. We would have been selling into a falling market for oil price stocks. While much of our sales would occur within a day or two, we assume an exit at the valuation that prevailed one week later on 14 December 2015 to allow for market impact and transaction costs. On that day, our basket had lost $3.9 million cumulatively, lowering portfolio performance by 2.5 percentage points.

Had we done this, we estimate we would have lost $1.2 million, with a total portfolio hit of 1.1 percentage points.[22]

4. **A variant of the prior point would be to think in terms of the maximum portfolio hit we were willing to absorb if wrong, and scale the trade accordingly.** For example, let's say that no matter what happened, we were unwilling to take more than a 1-percentage point hit to portfolio performance. If we use the 20% pessimistic case as a loss threshold, then we could have the 5% portfolio weight we started with. Alternatively, let's say we were willing to tolerate up to a 50% loss on the basket, the thinking being that if we've lost 50%, the trade likely is wrong; whereas, we couldn't be sure the trade was wrong when our loss was only 20%. In this case, if we still wanted to limit the hit to the portfolio to a maximum of one percentage point, then the basket weight could only be 2% of the portfolio.[23] With this rule, we estimate we would have lost $1.8 million and suffered a total portfolio hit of 1.2 percentage points.[24]

As mentioned in the second point above, it is essential to define ahead of time what your exit trade rule is. A disciplined trader will be reticent to invent a rule in the heat of the moment to justify an exit, as that often is a sign of capitulation (panic) that leads to selling around the low. If we developed the rule before the trade commenced, however, it would have been an unemotional decision to end the trade.

Conclusion

To conclude, even with foresight of knowing what happened, we don't think our oil basket was a bad idea per se. Even good ideas lose money some percentage of the time, and we did ground our idea in a study of oil price history and the observation that frontier stocks lag market turns. Further, as the Saudi production policy changes that caused much of the oil price selloff were voluntary, and could be reversed at any moment, few observers expected the selloff to become deeper than any price break in the prior three decades. We thought Saudi Arabia would have capitulated and reduced output as the oil price continued to fall. They never did.

But enough with any excuse making. We have a saying that if you lose half your money, you lose credibility to argue that your trade was a good one. What made this a bad trade was that we failed to design proper risk management that limited our losses. It's hard to say what we would have decided, but any of the four choices we outlined above would have led to a better outcome. A loss still, but a more manageable one, potentially as little as 1.1-percentage points in terms of portfolio impact, instead of 2.5 percentage points. Risk management is necessary because while history repeats, every episode has variations, and

---

[22] The basket first suffered a 20% cumulative loss on 27 July 2015. Prices then rose over the remainder of July. To allow for market impact and transactions cost, we assume we realized none of that appreciation, and exited at the 27 July prices, leaving us with a $1.2 million cumulative loss and a 1.1-percent-point performance hit.

[23] Global macro trader Colm O'Shea presents the concept of scaling the size of a trade based upon the percentage loss that tells you the trade is wrong and the amount you are willing to lose on the trade on page 42 of *Hedge Fund Market Wizards* by Jack Schwager, published by John Wiley & Sons in 2012.

[24] The basket first suffered a 50% loss on 7 January 2016. We would have been selling into a falling market for oil price stocks. While much of our sales would occur within a day or two, we assume an exit at the valuation that prevailed one week later on 14 January 2016 to allow for market impact and transaction costs. On that day, had our basket been only 40% of its actual size (sized initially to 2% of the portfolio instead of 5%), our cumulative loss would be $1.8 million, a 1.2-percentage-point performance hit.

it was naïve of us to assume that the downside we observed within the oil price history we studied represented the full range of outcomes this time around.

We think this episode shows also that ideas rarely perform in the timeframe you expect them to, even if your timeframe is based on past empirical results. Rather than have a fixed timeframe of a year, more or less, it would have been better to think in terms of milestones or events. This also lends itself to the risk management ideas mentioned above. Had we not been fixated on a one-year holding period, we would have been more willing to abandon the trade in December when it was clear that this oil price selloff was in unchartered territory relative to the prior five selloffs we studied.

Statistical Appendix

Figure 3
Frontaura Global Frontier Fund LLC
Performance[25]
30 June 2016

Period	Frontaura	S&P 500	MSCI EAFE	MSCI Emerging	MSCI Frontier
2016 Q1	- 1%	1%	- 3%	6%	- 1%
2016 Q2	4%	2%	- 1%	1%	0%
2008	- 28%	- 37%	- 43%	- 53%	- 54%
2009	46%	26%	32%	79%	12%
2010	37%	15%	8%	19%	24%
2011	- 15%	2%	- 12%	- 18%	- 19%
2012	18%	16%	17%	18%	9%
2013	26%	32%	23%	- 3%	26%
2014	- 3%	14%	- 5%	- 2%	7%
2015	- 5%	1%	- 1%	- 15%	- 14%
2016	3%	4%	- 4%	6%	0%
Inception to Date	76%	64%	- 13%	- 23%	- 33%
ITD CAGR	6.7%	5.9%	- 1.6%	- 3.0%	- 4.6%

Figure 4
Frontaura Global Frontier Fund LLC
Monthly Performance
30 June 2016

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2007											0.4%	1.6%	2.0%
2008	0.7%	0.6%	-0.1%	3.4%	3.9%	-1.0%	-0.8%	-2.2%	-7.9%	-17.5%	-10.7%	1.4%	-28.1%
2009	-2.0%	-0.4%	0.7%	7.7%	14.4%	4.1%	1.4%	4.7%	10.6%	-1.4%	-0.2%	0.2%	46.0%
2010	-0.9%	4.2%	6.6%	4.5%	-1.2%	1.9%	3.4%	0.7%	4.7%	3.5%	1.5%	3.3%	37.1%
2011	2.8%	-3.7%	2.7%	-0.4%	1.0%	-1.7%	-2.4%	-4.0%	-3.9%	-1.6%	-4.9%	0.7%	-14.8%
2012	-0.5%	3.9%	2.6%	2.4%	-4.4%	-1.3%	2.1%	1.4%	1.9%	2.6%	2.2%	4.3%	18.1%
2013	7.3%	1.9%	1.0%	1.8%	3.8%	-0.3%	2.6%	-2.1%	0.2%	3.1%	2.6%	1.6%	25.9%
2014	0.8%	-0.4%	-1.0%	1.6%	2.0%	0.1%	-0.3%	-0.8%	2.2%	0.9%	-4.5%	-3.3%	-2.9%
2015	-4.3%	1.0%	0.4%	3.9%	0.4%	-1.6%	-1.5%	-3.7%	-0.9%	3.3%	-2.4%	0.1%	-5.5%
2016	-4.8%	-0.6%	4.2%	1.8%	2.9%	-0.3%							3.1%

[25] Returns commence 1 November 2007. Frontaura returns are net of all fees, for an investor joining the fund at inception, making no further contributions, and making no withdrawals. Investors joining on other dates, making additional contributions, or making withdrawals may have different returns. Index returns are in US dollars on a total return basis, net of any withholding tax. Click this link for an explanation of the indices we show: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.

Figure 5
Frontaura Global Frontier Fund LLC
Portfolio Mix and Statistics[26]
30 June 2016

Country	Holding
Vietnam	10%
Sri Lanka	8%
Kenya	7%
Pakistan	7%
Papua New Guinea	7%
Nigeria	7%
Bangladesh	5%
Rwanda	5%
Tanzania	5%
Cambodia	3%
Romania	3%
Georgia	3%
Montenegro	3%
Argentina	3%
Serbia	3%
Lebanon	3%
Kuwait	2%
USA (cash only)	2%
Ghana	2%
Mongolia	2%
Oman	2%
Ecuador	2%
Macedonia	2%
Uganda	1%
Peru	1%
Qatar	1%
Botswana	1%
Mozambique	1%
Others	1%

Industry	Holding
Financials	48%
Consumer Staples	12%
Consumer Discretionary	10%
Utilities	7%
Industrials	5%
Energy	5%
Cash	5%
Materials	5%
Telecommunication Services	2%

Portfolio Statistics

Portfolio Price to LTM Earnings	7.1
Portfolio Price to Book	1.1
Portfolio LTM Dividend Yield	6.1%
Return on Ending Equity	19.8%
Positions	54
Countries	29
Average Market Cap	$651m
Median Market Cap	$262m
Portfolio Turnover (LTM)	39%
Portfolio Turnover (ITD)	28%
Standard Deviation (ITD)	14%
Beta to S&P 500 (ITD)	0.51
Assets Under Management	$117m

[26]Click this link for an explanation of our holdings and portfolio statistics: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.

Figure 6a
Frontaura Global Frontier Fund LLC
5 Best and Worst Performing Countries (Dollar Return)
2016 Q2

5 Best Countries				5 Worst Countries			
Country	Frontaura Return ($millions)[27]	Frontaura Return (%)	MSCI Return[28]	Country	Frontaura Return ($millions)	Frontaura Return (%)	MSCI Return
Vietnam	2.8	21%	11%	Montenegro	-0.7	-15%	--
Georgia	0.9	34%	--	Ghana	-0.6	-19%	-14%
Papua New Guinea	0.9	12%	--	Tanzania	-0.2	-3%	--
Bangladesh	0.8	14%	10%	Romania	-0.1	-3%	-1%
Pakistan	0.4	5%	14%	Qatar	-0.1	-9%	-5%

Figure 6b
Frontaura Global Frontier Fund LLC
5 Best and Worst Performing Countries (Percentage Return)
2016 Q2

5 Best Countries				5 Worst Countries			
Country	Frontaura Return ($millions)	Frontaura Return (%)	MSCI Return	Country	Frontaura Return ($millions)	Frontaura Return (%)	MSCI Return
Angola	0.0	34%	--	Ghana	-0.6	-19%	-14%
Georgia	0.9	34%	--	Montenegro	-0.7	-15%	--
Vietnam	2.8	21%	11%	Mozambique	-0.1	-10%	--
Bangladesh	0.8	14%	10%	Qatar	-0.1	-9%	-5%
Iraq	0.0	13%	--	Tanzania	-0.2	-3%	--

[27] This footnote applies to all columns labeled "Frontaura Return ($millions)" and "Frontaura Return (%)" on this page and the following page. Frontaura country returns are before management fees, fund expenses, and any incentive compensation, as those deductions occur at the fund level and not at the individual stock or country level. Click this link for an explanation of how we calculate country returns: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.

[28] This footnote applies to all columns labeled "MSCI Return" on this and the following page. MSCI country indices stated on a total return basis with dividends net of any withholding tax. We show "--" if MSCI does not have an index for a given country.

Figure 7a
Frontaura Global Frontier Fund LLC
Significant Quarterly Country Mix Changes[29]
2016 Q2

Country	Percentage Point Change	Explanation
Kenya	+4	Added multiple positions
Georgia	+3	Added new position
Kuwait	+2	Added new position

Figure 7b
Frontaura Global Frontier Fund LLC
Significant LTM Country Mix Changes
2015 Q3 – 2016 Q2

Country	Percentage Point Change	Explanation
Kenya	+7	Added multiple positions throughout, offset by smaller position sale in Q3 2015
Georgia	+3	Added new position in Q2 2016
Kuwait	+2	Added new position in Q2 2016
Rwanda	+2	Added new position in Q4 2015, partially offset by trims in Q3 2015
Pakistan	+2	Added new position in Q3 2015, partially offset by trims in Q3-Q4 2015
Vietnam	- 3	Numerous position exits throughout, offset by new positions and outperformance

[29] We show countries whose weighting has changed by two percentage points or more. Total may not add to 0 due to rounding and exclusion of countries changing by less than two percentage points. Note that we do not show the United States as we only hold cash there. Click this link for a discussion of how we classify cash by country: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.

Figure 8
Frontaura Global Frontier Fund LLC
Portfolio Concentration[30]
30 June 2016

	Companies	Countries	Change from Prior Quarter		Change from Prior Year	
			Companies	Countries	Companies	Countries
Positions	54	29	+2	-2	-3	-9
Top 5	22%	39%	--	--	-1	-1
Top 10	37%	64%	--	+3	+1	+5
Top 20	62%	90%	+1	+3	+5	+11
Top 20 + USA (Cash)	65%	92%	-6	-4	-3	+3

[30] We do not include the US in our country count and most of the percentage totals as we hold only cash there. Change from the prior quarter and the year ago quarter represent the change in the number of positions and the change in percentage points for the top 5, 10, and 20 positions. The Top 20 + USA row does include the US cash percentage in the percentage totals. Click this link for a discussion of how we classify cash by country: http://www.frontauracapital.com/disclosures/Frontaura_Disclosures_as_of_2015_09_30.pdf.