# THIRD AVENUE INTERNATIONAL VALUE FUND



Matthew Fine, CFA | Lead Portfolio Manager

Dear Fellow Shareholders:

For the three months ended March 31st 2017, the Third Avenue International Value Fund returned 8.63%[1] as compared to MSCI AC World ex US Index , which returned 7.98%[2]. During the quarter, Fund performance benefited from our investments in Arcos Dorados Holdings, Global Logistic Properties, Capstone Mining, Compagnie d'Enterprises CFE and IWG plc, which provided our five largest positive contributions to performance. Our most significant detractor from performance was our equity investment in Petroleum Geo-Services.

## THE PARADOX OF "RISK"

*"If there is one thing that differentiates our approach from that of others writing on investments, it is our underlying conviction that the value of the business has no necessary relationship to the price of its common stock."*

-Martin J. Whitman
***The Aggressive Conservative Investor*** (1979)

In our quarterly letters to shareholders we frequently discuss aspects of the Third Avenue Management investment philosophy which distinguish our approach from other active investment management firms and from conventions deeply entrenched within academic finance. Past discussions have included our focus on balance sheet strength as a source of risk mitigation as well as a source of returns, which is in contrast to the primacy of the income statement emphasized by most active investors. Other discussions have focused on the implications of employing a long-term investment philosophy combined with a concentrated portfolio management approach, which will almost certainly produce a differentiated return profile as compared to more diversified funds and indices. With this letter we would like to discuss concepts of risk, specifically whether volatility is a useful proxy for risk. This is no small matter considering that most academic study of investing hinges upon the use of volatility as its primary measurement of investment risk. We hope it is clear from past letters that, with regard to investment risk, we place virtually all emphasis on fundamental business risk and virtually no emphasis on security price volatility. This letter intends to describe the short-comings of a focus on security price volatility and how a focus on fundamental risk factors guides our activity.

As a preface, we should acknowledge that if one's investment horizon is one or two quarters, which is not rare in the fund management industry, price volatility may be a rational consideration. For those employing longer-term investment approaches, price volatility becomes almost entirely irrelevant. Quantifications of price volatility are by definition backward looking. Volatility measurements tell us what has been experienced over some historical period, which does not inherently have any connection to volatility in future periods. When making investment decisions we are concerned with the future, not the past, and future volatility is not measurable ex ante. Therefore, volatility's use in risk measurement and management is akin to driving while looking in the rear-view mirror. You had better hope that the road in front of you looks very much like the road behind, which is more likely to be the case if you are concerned with the next ten feet of road rather than the next ten miles.

So, even in the event that one considers volatility to be a valid proxy for risk (we absolutely do not), there is no inherent connection between recently experienced volatility and volatility to be experienced well into the future. Peter Bernstein summarized this concept beautifully in *Against the Gods, The Remarkable Story of Risk*:

*"Even though risk means that more things can happen than will happen – a definition that captures the idea of volatility – that statement specifies no time dimension. Once we introduce the element of time, the linkage between risk and volatility begins to diminish. Time changes risk in many ways, not just in its relation to volatility."*

A skeptic might argue that financial markets are full of brilliant, dedicated people. How then could they collectively place so much reliance upon a system of measuring and managing risk that is so fundamentally flawed? I believe two ubiquitous behaviors help answer that question. The first, psychologist turned Nobel Prize winning economist, Daniel Kahneman, would describe as the substitution heuristic. When posed with a question for which the necessary information is unavailable, people reflexively and subconsciously replace the question with one that is seemingly very similar and for which necessary information is available. In Kahneman's words, "People are asked for a prediction but they substitute an evaluation of the evidence, without noticing that the question they answer is not the question they were asked. This process is guaranteed to generate predictions that are systematically biased; they completely ignore regression to the mean." For example, if we posed the question, "what will our president's approval rating be *two years from now?*" you are very likely to find yourself considering what his approval ratings are *today*.

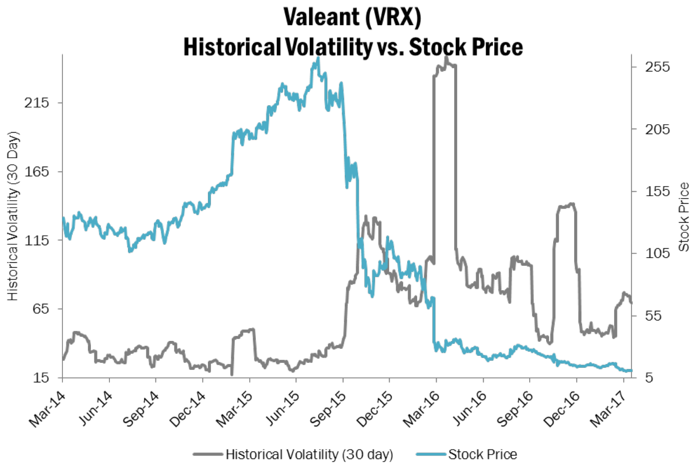
1 **Please see Appendix for performance table and information.**

2 The Morgan Stanley Capital International All Country World ex USA Index is an unmanaged index of common stocks and includes securities representative of the market structure of over 50 developed and emerging market countries(other than the United States) in North America, Europe, Latin America and the Asian Pacific Region.

If so, you have made a heuristic substitution because we lack the necessary information with which to answer the question asked. In our discussion, the unanswerable question of "what will a security's price volatility be in the future?" is being replaced or proxied by "what has volatility been in the past?" The latter can be answered while the former cannot, particularly over any lengthy period of time. The second behavior is an overwhelming compulsion by financial professionals to measure things, ideally reducing them to a single easily-digestible numeric value (earnings per share, for example). In the same way that earnings per share falls painfully short of fully describing the economics of a business, so too does volatility fall painfully short of describing risk. This tendency may arise from the desire to remove aspects of art and judgment from investing and entrench the industry in the realm of "hard" sciences. Lord Kelvin embodied the compulsion, though he wasn't speaking about finance specifically, when he said "…when you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind." Unfortunately for us long-term investing practitioners, when dealing with powerful fundamental risk factors, such as political risk or technological obsolescence risk, they are simply not measurable or quantifiable with any degree of precision. As it relates to fundamental investment risk, Kelvin is correct that our understanding is, and will continue to be, "of a meagre and unsatisfactory kind." Yet, substituting an irrelevant number (historical volatility) that can be measured with precision in place of a less quantifiable set of fundamental risk assessments in no way furthers our understanding of risk. To be very clear, the admission that our understanding of risk will remain of an "unsatisfactory kind" does not diminish the value of analyzing myriad types of fundamental risk simply because we can't quantify them with precision and combine them into a single tidy numeric package. In the context of long-term investing, the critical point regarding risk assessment and management is that it is more sensible to stare intently into the fog, developing a somewhat murky view of shapes and sizes, than to look in the wrong direction to see with perfect clarity.

In securities markets, periods of elevated volatility are most often associated with meaningful declines in prices - e.g., some type of negative event gives rise to a rapid price decline, which will produce high price volatility. We will return to this topic with specific examples momentarily but we begin with the general statement that it is anathema to us, as it is for most value investors, to suggest that an investment is necessarily riskier because its price has recently experienced a sharp decline. Warren Buffet was feigning to grapple with this paradox when he famously said, "I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than for $80 million." All else being equal, price reductions reduce risk, they don't create risk. Further, if the manifestation of fundamental risk has given rise to a security's fall from grace and, by extension, increased its price volatility, then by definition said fundamental risk existed within the security prior to its manifestation. The causal relationship is that investment risk has caused volatility, not the reverse, and the lens of volatility is only looking backward at market reactions to investment risk. Imagine taking a flight from an airport shortly after it has been the scene of some type of terror incident. Although it may be a very unnerving experience it is likely considerably safer than prior to the incident. Even though we might have been more at ease in our false sense of security prior to the tragedy, it is probable that we were fundamentally less safe. Alternatively, imagine the scenario of a ne'er-do-well management team who gradually destroys the value of your capital over an extended period of time (I won't name names). There is no event or cataclysm per se, just a long slow death. That scenario is unlikely to give rise to heightened price volatility but is replete with devastating risk. Therefore, not only is volatility backward looking but its use as a proxy for risk has a tendency to suggest heightened risk in some situations that have become fundamentally safer and will also fail to give the slightest hint of grave fundamental risk given certain patterns of losses.

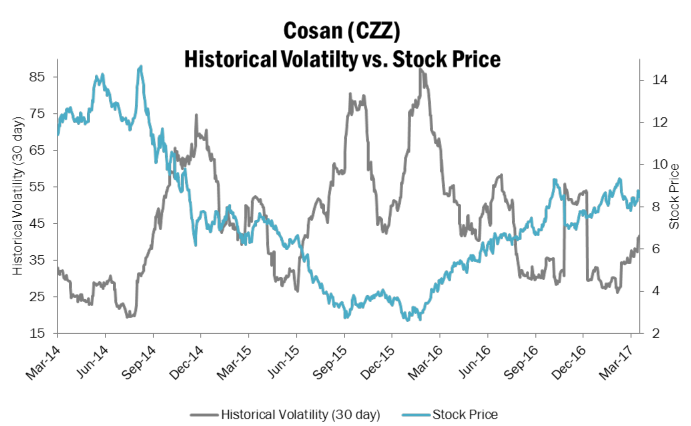
Let's now return to specific examples of the paradox of volatility. Valeant Pharmaceuticals International was a darling of the investment industry until mid-2015. The details of the Valeant saga are beyond the scope of this letter but I think most would agree that certain business practices employed by the company subjected investors' capital to significant fundamental risk. The rear view mirror of low levels of price volatility gave no indication of those risks; then there was a catastrophic head-on wreck. Following the wreck, measurements of volatility spiked in mathematical response to large downward stock price movements. Paradoxically though, as volatility measurements were rising, an investment in the company's stock was actually becoming fundamentally safer (I did not say safe). We present the paradox graphically below. One can observe trough levels of volatility coincident with peak levels of pricing. Further, volatility levels at the moment immediately prior to the implosion were relatively low in an absolute sense, suggesting a safe investment within the risk framework of academic finance. Yet were one to have invested in Valeant common stock coincident with the lowest measured volatility (30 day trailing) during the last three years, which occurred on February 20th, 2015, approximately six months before Valeant's dramatic descent began, the loss experience through March 31st, 2017 would be approximately 94%. Paradoxically, were one to have invested at the moment of peak volatility on April 8th 2016, which resulted from a radical decline of the stock price in response to actual fundamental risks coming home to roost, the loss experience would be 67% through March 31st, 2017. It's an outstanding example of why we dissociate volatility.




Source: Bloomberg

To the extent that one believes, as we do, that there are many causes for fluctuations in volatility, one might abandon any prima facie attraction to investing in low volatility investments, popular as they may be. One might even begin to make a habit out of searching for investment opportunities in the midst of heightened volatility, which frequently results from a steep decline in security price, possibly creating a great bargain. With that in mind, let's now turn to an example of the opportunity side of volatility.

In mid-2014 we observed that the stock price of a Brazilian company we had known for years, Cosan Limited, had fallen from recent highs of roughly USD 21 per share to roughly USD 12 per share over a period of approximately twelve months. Our analysis suggested that the stock presented a good, but not great, opportunity. Strictly on the basis of price-consciousness, we opted to wait and hope for a superior opportunity. We could not have imagined that a little more than one year later, in August 2015, we would begin purchasing shares in the mid USD 3 per share range. We continued to purchase shares as the share price continued to decline through February 2016, reaching a low of roughly USD 2.60 per share. Below we offer the same graphic exercise conducted for Valeant above. You may quickly observe the similar inverse relationship between the price of the equity and its measured volatility, with volatility lows coincident with the price peaks and volatility peaks coincident with equity price lows.




Source: Bloomberg

Some would offer the counterpoint that the Fund had purchased a very volatile equity in August 2015 and incurred mark to market loss on our investment of more than twenty percent in the first six months of ownership. This is true and is an example of why we noted at the beginning of our essay that if one has an investment horizon of one or two quarters it could conceivably be rational to be concerned with recent price volatility of securities under review. Whether you prefer Benjamin Graham, who offered the quip "in the short run, the stock market is a voting machine but in the long run, it is a weighing machine," or recall Bernstein's observation, "Once we introduce the element of time, the linkage between risk and volatility begins to diminish" the principle is the same. We flatly reject the notion that it safer to buy shares of Cosan Limited at USD 21 per share than at USD 3 per share simply because its stock price fluctuations had been very moderate in its run up to peak prices of USD 21 per share. As Benjamin Graham, Warren Buffet and Marty Whitman have long known, price-consciousness and risk-consciousness are inextricably intertwined, meaning that paying very low prices for an investment is a powerful way of reducing risk of loss of your capital.

## INVESTMENT ACTIVITY & UPDATES

**IWG plc ("IWG")** In early January 2017 we began to purchase shares of IWG plc, until recently known as Regus plc. IWG is the world's largest provider of shorter-term office space solutions, sometimes referred to as "workspace as a service." While the vast majority of the company's offering carries the Regus label, the company is evolving into a more segmented and multi-branded offering, hence the name change. The company's founder, Mark Dixon, pioneered the industry, which has been rapidly growing its utility to corporations and individuals for nearly two decades. IWG is the early mover and has unrivalled scale. Its nearest competitors, including one recently accorded a "unicorn" valuation, are a mere pittance of its size and revenue. IWG also distinguishes itself by being highly profitable. Our entry point into our IWG investment was created by two factors. First, in recent years IWG had undertaken a significant multi-year expansion of its network, which required a considerable level of capital expenditure by the company. The nature of the business is such that new locations take time to mature, reaching occupancy levels needed to produce the intended level of profitability. As a result, recent operating performance exhibits less of the things many analysts tend to care a lot about – current free cash flow, near-term profit growth and returns on invested capital – all of which were depressed, temporarily we suspect, by the wave of investment we described. It is worth noting though that this same lumpy cadence of investment activity is how the company and its founder have produced their tremendous long-term record of business value growth. Second, although its operations are global in scope and North America is its largest geographic focus, IWG is listed in London. In the first few days following the June 2016 Brexit referendum vote, IWG lost nearly 30% of its value in U.S. dollar terms as a result of stock price declines and a steep drop in the British pound, the currency in which it trades. The implicit suggestion was that its entire UK operations were worthless, which is of course nonsense. The stock did not recover as 2016 progressed. In short, our view was that the façade of poor operating profitability was likely to be fleeting with a little time to allow for recently made investments to mature. We also believe that, even on the basis of the status quo, the company had become attractively valued as a result of British pound and stock price declines, particularly so for a very well-financed business.

**Hibernia REIT plc ("Hibernia")** In March 2017, we began to establish a position in Hibernia, which is an office REIT focused exclusively on central business districts in Dublin, Ireland. Although Hibernia has a market capitalization of less than EUR 1 billion, it is one of the dominant office property developer/owners in the fairly small office market of Dublin. Hibernia offers a reasonable return and is exceptionally well-capitalized. However, Hibernia has several things working in its favor prospectively. First, the company has a considerable development pipeline which is being met by strong and growing demand for Dublin office space. Second, the company's current income is very likely to benefit from rental reversions as older leases are re-priced at materially higher prevailing market prices. Finally, intuition and early movements from London, an office market facing considerable uncertainty, suggest that Dublin is a likely destination for some portion of Brexit-related corporate staff relocation. Dublin's small size and very low vacancy rates suggest that space in this market could come to be richly valued. Failing that scenario, we would expect to earn the reasonable status quo return.

**Tenon Ltd ("Tenon")** In our last quarterly letter, I offered the following comment on our investment in Tenon:

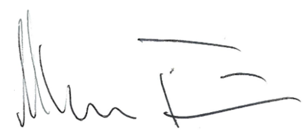
*"With regard to its New Zealand operations, Tenon announced several weeks ago that it had entered into exclusive discussions with an interested party with the intention of arriving at a binding sale transaction. Should a transaction be consummated, Tenon would cease to have any business operations and would go through a liquidation and wind-up process with the transaction proceeds again distributed to shareholders. We expect that distributions from such a process are likely to represent a meaningful premium the company's current share price."*

In February, Tenon announced the expected transaction and its intention to proceed with a capital distribution and liquidation process as expected. However, the agreed upon sale price of this business was a disappointment to me. My estimation of the value a private buyer would be willing to pay for this business was apparently optimistic and therefore simply incorrect. As a result, Tenon made a modest negative contribution to our performance during the quarter. The company intends to distribute the vast majority of the liquidation proceeds in April and the residual tag-end distribution by year end. This process is expected to bring closure to our nearly eight year investment in Tenon. In spite of this last bout of disappointment the investment overall produced very positive results.

We thank you sincerely for your confidence and your loyalty. We look forward to writing again next quarter but welcome all interest in the Fund in the meantime.

Sincerely,

The Third Avenue International Value Team



Matthew Fine

Lead Portfolio Manager

March 31, 2017

## FUND PERFORMANCE

| *as of 3/31/17* | 1 yr | 3 yr | 5 yr | 10 yr | Since Inception | Inception Date |
|---|---|---|---|---|---|---|
| TAVIX (Institutional) | 24.92% | -1.16% | 4.00% | 1.30% | 7.62% | 12/31/2001 |
| TVIVX (Investor) | 24.73% | -1.40% | 3.75% | (n/a) | 3.61% | 12/31/2009 |

## TOP TEN HOLDINGS

| | % of Portfolio |
|---|---|
| Arcos Dorados Holdings, Inc. | 6.3 |
| Capstone Mining Corp. | 5.1 |
| Rubicon, Ltd. | 4.8 |
| Global Logistic Properties Ltd. | 3.9 |
| easyJet PLC | 3.5 |
| Amec Foster Wheeler PLC | 3.5 |
| Petroleum Geo-Services | 3.4 |
| Interfor Corp | 3.4 |
| Cie D'Entreprises CFE | 3.1 |
| Lundin Mining Corp. | 3.0 |

*Allocations subject to change*

*Past performance is no guarantee of future results; returns include reinvestment of all distributions. The above represents past performance and current performance may be lower or higher than performance quoted above. Investment return and principal value fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. For the most recent month-end performance, please visit the Fund's website at www.thirdave.com. The gross expense ratio for the fund's institutional and investor share classes is 1.40% and 1.65%, respectively, as of March 1, 2017. Please be aware that foreign securities from a particular country may be subject to currency fluctuations and controls, or adverse political, social, economic or other developments that are unique to that particular country or region. Therefore, the prices of foreign securities in particular countries or regions may, at times, move in a different direction than those of U.S. securities. Prospectuses contain more complete information on management fees, distribution charges, and other expenses.*

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Current performance results may be lower or higher than performance numbers quoted in certain letters to shareholders.

Date of first use of portfolio manager commentary: April 19, 2017

THIRD AVENUE MANAGEMENT

www.thirdave.com

/third-ave-management

Third Avenue offers multiple investment solutions with unique exposures and return profiles. Our core strategies are currently available through '40Act mutual funds and customized accounts. If you would like further information, please contact a Relationship Manager at:

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