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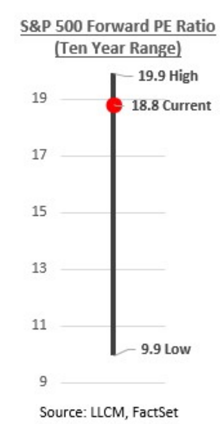
Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide an overview of three new equity holdings: American International Group (AIG), Las Vegas Sands (LVS), and Philips 66 (PSX). A brief summary of the letter is as follows:

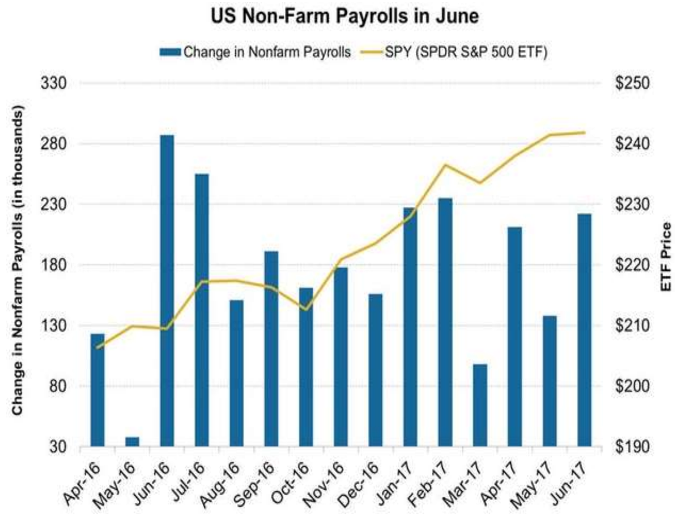
- The market's valuation is elevated, but stocks are likely being supported by solid earnings growth and the Trump agenda's eventual (if ever?) roll out
- Global monetary policies are no longer tailwinds for stocks. Tightening into a slowing economy is potentially concerning.
- Economic data are choppy, but still mainly positive.
- 90% of daily trading volume is done by algorithms/robots and there are now more ETFs than US-listed stocks! This dynamic poses risks and opportunities.

Beginning with our thoughts on the market, it appears most investors are focused on ramifications from the eventual (if ever?) rollout of the Trump agenda, of which, the three major components – health care reform, tax reform, and infrastructure spending – are all expected to be positive for equities. While the market has been almost eerily calm, periods of volatility have occurred as various developments impact the agenda's timing. Currently, President Trump wishes to accomplish healthcare reform before addressing the agenda's other components. As such, when healthcare faces a setback, the market declines. So far, the selloffs have been short-lived, as Trump could simply decide to address healthcare later, an event that would likely send stocks higher – no money manager wants miss the boat should that occur. The case can be made that the looming Trump agenda has set a floor in US equities.



On the valuation front, the S&P 500 trades at 18.8x 2017's earnings and 16.8x 2018's projected earnings, both multiples are near the top end of this historic ranges. The S&P 500 is expected to report earnings growth of 6.4% for 2Q17. As of July 21st, 19% of the companies in the S&P 500 have reported 2Q17 results with 73% reporting EPS above estimates by an average of 7.8%, which is above the five-year average. In terms of sales, 77% are reporting sales above consensus, beating by an average of 1.3%, both metrics are above their respective five-year averages. So, despite a relatively small sample size, both earnings and revenue trends appear supportive for stocks.

On the economic front, US data remains much as it has since the end of the Great Recession: choppy, but generally trending positive over longer durations. For instance, retail sales were +0.5% in January, -0.2% in February, +0.1% in March, +0.4% in April, and -0.3% in May. Year-over-year wage growth has bounced between +2-3% dating back to 2013, and non-farm payrolls growth has been similarly lumpy, but positive, as evidenced in the adjacent chart.



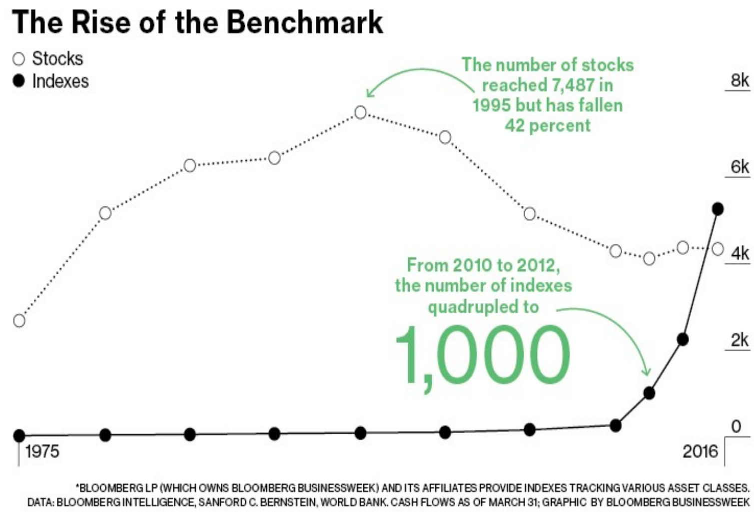
In regards to central banks, and particularly the US Federal Reserve, one of the larger areas of focus for investors continues to be monetary policy. Globally, most of the major central banks are tightening policies through higher interest rates and shrinking their balance sheets via allowing bonds to mature without being replaced. Given somewhat choppy economic data, the argument can be made that central banks are tightening into a slowing economy. If true, this would likely be negative for stocks, though it is worth mentioning that rates are still quite low by historic standards.

We are also keeping a close eye on the developing situation in China as it relates to debt levels. The country recently completed its National Financial Work Conference, which is held once every five years and aims to address various financial topics. President Xi Jinping attended the meeting, which was unexpected, and called on state owned entities to reduce leverage on their balance sheets. Currently, China's debt to GDP stands at 260%, and climbing, with two thirds of the debt held by non-financial companies. To date, Chinese defaults have not had an impact on global equity markets, but increased scrutiny of the situation coming from the upper echelons of government is potentially significant.

Finally, a note from JPMorgan, regarding algorithmic trading, and a report from Bloomberg, regarding the rise of ETFs, caught our attention. In the JPMorgan note, researchers estimated that "fundamental discretionary traders account for only about 10% of trading volume in stocks today" and that "the majority of equity investors today don't buy or sell stocks based on stock specific fundamentals"[1]. From our standpoint, if the majority of a given day's trading volume is not rooted in fundamentals and ignores a stock's valuation, it may provide an opportunity as some stocks are likely being sold for dubious reasons. On the other hand, by ignoring fundamentals and valuation, it is possible to envision a scenario where an equity bubble is being created.

[1] https://www.cnbc.com/amp/2017/06/13death-of-the-human-investor-just-10-percent-of-trading-is-regular-stock-picking-jpmorgan-estimates.html

The report from Bloomberg was equally startling, as it stated: "The number of [ETFs] now exceeds the number of U.S. stocks. Traditional [indexes] such as the S&P 500 are collections of securities weighted by market value, and [ETFs] mimic them as a low-cost way to deliver the market's performance. Many new [ETFs] are different: They include stocks based on custom criteria, such as having low volatility or high dividends."[2] Again, this dynamic may present the same opportunity/risk dynamic discussed earlier as most ETFs are indifferent to valuation and simply designed to provide exposure to a specific investment criteria. As the saying goes, valuation doesn't matter until it does.



We hope you enjoyed the letter, and as always, please do not hesitate to contact us with any questions.
All the best,
Long Lake Capital Management, LLC

<u>Select Equity Holdings Update</u>

American International Group (AIG, $64.25/share, $59B market cap)
AIG is a leading insurance company with an international presence. It provides both property and casualty "P&C" as well as life insurance products. AIG has been plagued by a pattern of write-offs in its legacy business, which has limited its book value growth (the most important metric for insurance companies) and caused concern about its underwriting discipline.

After the most recent write-down in 4Q16, the board of directors decided to replace CEO Peter Hancock. The new CEO, Brian Duperreault, was appointed in May of 2017 and is a respected, seasoned insurance executive. He intends to bring underwriting discipline back to AIG and restore consistent profitability, which will drive EPS and book value growth. Duperreault began his career at AIG in 1973 and moved up the ranks until 1994 when he left to become CEO of ACE Insurance, which recently completed a $28B merger with Chubb. Under Duperreault, ACE was known for stringent underwriting and was often viewed as "best of breed" in the industry. Duperreault retired in 2004, but was lured out of retirement in 2008 to orchestrate a turnaround at troubled insurer Marsh & McLennan (MMC, $40B market cap) driving the stock higher by ~40% over his four year tenure. After successfully completing MMC's turn around, Duperreault formed Hamilton Insurance

[2] https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks

Group, which places a strong emphasis on technology to better price risk. Of note, in tandem with naming Duperreault CEO, AIG acquired Hamilton for $110M. Despite having sizable personal wealth, Duperreault is incentivized with AIG stock as he was awarded 1.5M stock options with an exercise price starting at $61/share. 500,000 vest immediately and the remaining 1,000,000 vest in 333,333 increments over the next seven years with exercise prices of $71, $81, and $91.

Prior to hiring Duperreault, AIG's remaining legacy insurance risk, which has been the source of many write-offs, was reinsured by Berkshire Hathaway. This largely mitigates negative reserve development going forward, as Berkshire will take 80% of reserve development charges in troubled lines.

So far, the only comments Duperreault has publicly made are that he is focused on premium growth, improving profitability, growing book value, and does not want to shrink – meaning he may make acquisitions as he did during his time at ACE. Also, he is not interested in splitting the P&C business from the life insurance business as some (including Carl Icahn) have pushed for. Nonetheless, Icahn's presence on the board adds activist involvement.

Currently, AIG trades at 10x earnings and at 0.82x its $78/share book value. Consensus estimates call for $91 in book value by 2018, which would imply a stock price of ~$75, representing a 15% return. However, with improved profitability and underwriting, a higher multiple would likely be warranted. For instance, the peer group's average book value multiple is 1.12x, which would imply ~$100/share for AIG in 2018, a 56% return – while 56% is likely optimistic, a successful turnaround could result in substantial upside for investors.

Las Vegas Sands (LVS, $62.00/share, $49B market cap)
LVS is a world-class casino resort operator with domestic (Las Vegas: The Venetian and The Palazzo; Bethlehem, PA: Sands Bethlehem), and Asian (The Venetian Macau, Sands Coati Strip, Four Seasons Macau, Sands Macau and Marina Bay Sands in Singapore) exposure. Despite its US headquarters, the company derives 58% of its revenue from Macau and 24% from Singapore. The remaining 18% is derived domestically. From an EBITDA standpoint, the numbers are 54%, 32%, and 14%, respectively.

The company's outspoken founder and CEO, Sheldon Adelson, is also its largest equity holder with 431.8 million shares. Mr. Adelson, who grew up sleeping on the floor of his parent's tiny Boston apartment, is currently ranked 20th on the Forbes Billionaire List with an estimated net worth of $34.9B.

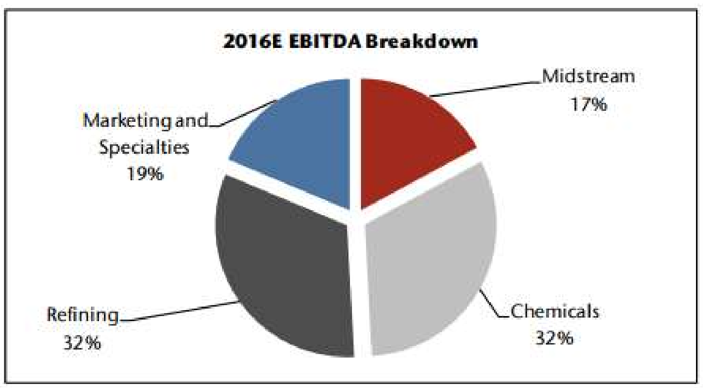
As previously alluded, LVS is really an Asian gambling growth story. Macau's yearly gross gambling revenue (GGR) is roughly eight times that of Las Vegas' and growing in excess of 20% year over year. It is truly a staggeringly large market despite periodic attempts by the Chinese government to limit visitors (visa restrictions) to the island and/or crack down on junket operators and money laundering. Junkets are essentially liquidity providers that steer VIP clients to various casinos. Some junkets operate in a "gray" legal area, while others are publicly traded and seemingly legitimate. We acknowledge that junkets and government intervention are an odd dynamic and potential investment risk, but it is worth pointing out that LVS's Macau operations generate only 11% of profits from the VIP segment. The remaining 89% of profits are generated by mass table gaming (50%), hotel rooms (15%), mall leasing fees (14%), slots (8%) and other (2%). On the government intervention side, all efforts to date have not derailed the region's long-term growth.

Casino operation, while economically sensitive, is a good business. LVS' most recent quarter produced an industry leading adjust EBITDA margin of 36.7% and an operating margin of 21.8%. Returns on invested capital (ROIC) typically range in the high teens, but are expected to expand into the high twenties as development spending slows.

Outside of Macau and Singapore, Japan is the next major area of focus in the Asian region. LVS is expected to receive one of only two Japanese urban gaming licenses in late 2019, and would likely be able to open a resort in the country during 2024 that will represent a mid-teens percentage of total company EBITDA in that year and generate ROIC around 20%.

From a valuation standpoint, LVS trades at a discount to the Macau-exposed casino peer group on a PE, EV/EBITDA, and EV/EBIT basis despite having the least financial leverage, a higher dividend yield (5.9%), and less exposure to junket regulation via greater reliance on mass gaming than VIP gaming.

Phillips 66 (PSX, $82.50/share, $42.5B market cap)



PSX owns and operates refining, pipeline, terminaling, chemical manufacturing, and petroleum products marketing assets worldwide. PSX owns and operates a total of 14 refineries, with 11 located in the US and the remaining three located in Europe. PSX's pipeline portfolio consists of 2,854 miles of crude pipeline, 5,967 miles of refined product pipeline, 3,925 miles of NGL pipeline, 1,107 miles of LPG pipeline, and 1,712 miles of natural gas pipeline. PSX's terminal capacity consists of 20.3 million barrels of refined product terminal capacity and 13.8 million barrels of crude terminal capacity, with accompanying rail and marine loading/unloading rack facilitates. Via its joint venture with CPChem, PSX has interest in 34 chemical manufacturing plants located around the globe and two research & development facilities located in the US. PSX markets gasoline and diesel through approximately 8,350 retail outlets in the US and markets its aviation fuel through roughly 850 retail outlets.

Additionally, PSX has a 50% ownership interest in DCP Midstream, LLC, which owns and operates 64 natural gas processing facilities with an aggregate processing capacity of 8.0 billion cubic feet per day, in addition to approximately 69,000 miles of pipeline, including gathering systems associated with its processing facilities and natural gas transmission pipelines. Additionally, DCP Midstream owns or operates 12 NGL fractionation plants. DCP Midstream, LLC is the General Partner and a ~21.5% Limited Partner in DCP

Midstream Partners, LP, an affiliate MLP. Spectra Energy Corp. (SE) owns the remaining 50% of DCP Midstream, LLC.

PSX owns 100% of Phillips 66 General Partner (PSPX, $5.3B market cap), the general partner of PSXP, which owns a 2.0% GP interest and ~58% LP interest in PSXP. PSXP owns and operates 916 miles of refined product pipeline and 39 miles of crude oil pipeline, in addition to marine terminal assets. PSXP also has partial interest in 1,830 miles of refined product pipeline, 2,130 miles of NGL pipeline, and 60 of crude oil pipeline.

PSX was formed via a spin-out from ConocoPhillips (COP, $54B market cap) in 2012 and is headquartered in Houston, TX. Of note, Berkshire Hathaway currently owns ~15.5% of PSX's common stock.

Investing in the energy sector can be challenging given the volatility of oil and natural gas prices. For instance, WTI[3] Crude Oil was over $100/barrel in 2014, briefly traded under $30/barrel in 2016, and has recovered to the ~$45/barrel level in 2017. PSX has exposure to nearly every facet of the energy value chain as its diverse portfolio links growing US hydrocarbon supply to end-use markets including refining, marketing, and chemicals. While its 2.2 million-barrel-per-day of refining capacity and 50% interests in DCP Midstream and CPChem yield direct exposure to fluctuating commodity prices, the company's primary growth engine is its stable of predominantly regulated, fee-based transmission, storage and distribution assets.

From a current earnings standpoint, PSX also provides a way to gain exposure to the energy space without taking on as much commodity price risk as a portion of the company's current profitability is driven by "crack spreads", or price differential between the price of crude oil and the refined petroleum product (i.e. gasoline, diesel etc.). While refiners typically trade directionally with oil prices, their moves have historically been less volatile – perhaps even more so with PSX given its other earnings drivers. One final point of note, the roughly 30% spread between the S&P 500's year-to-date performance and the energy sector's year-to-date performance has never been wider.

[3] West Texas Intermediate is the most commonly quoted US-based crude oil price