FRANK VALUE FUND

UNCONSTRAINED INVESTING IN US EQUITIES

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Frank Capital Partners LLC

Q4 17 LETTER TO SHAREHOLDERS

The Frank Value Fund Investor Class returned (-2.81%) in 2017 compared to 21.83% for the S&P 500 TR Index. Please see the end of this letter for more performance information.

In 2017 doing the opposite of what our value principles dictated would have been extremely lucrative. This market feels like warning your friend against spending his entire paycheck on lottery tickets, only to see your friend win thousands of dollars and question your intelligence. The temptation to abandon one's principles and make easy money is enormous and is exhausting the patience of other investors. Just like the Internet bubble in the late 1990s, we are witnessing our peers shutting down their firms or changing their strategies. After the market turns towards rationality there will be even less competition for those of us who are cash-rich. We view our strategy as a long-term discipline, avoiding manias and investing when opportunity is great. We will always abide by our process.

Though it is difficult to wait, approaching this environment as a business owner rather than a stock speculator illuminates the pitfalls we see in most equities and the opportunities in our portfolio. Here is an example using portfolio holding Liberty Tax and a typical blue-chip company with a bubble valuation, McDonald's.

McDonald's multi-decade success has saturated the global market with restaurants, limiting growth in locations to 2-3% per year. As an owner, you have the safety of the best in class competitor, but the future growth is limited. The current FCF/EV (free cash flow to enterprise yield) for McDonald's is 2.0%. Thinking like a business owner, if you were to take McDonald's stock (NYSE:MCD) private, this translates to a payback period of roughly 50 years! That's 50 years before you make back your purchase price and begin to see a return on your investment! That's a lot of chicken nuggets.

What made 2017 so frustrating as a value investor was McDonald's started the year with a 3.4% FCF/EV yield, trading at a 30-year payback from free cash flow, yet bigger fools were abundant, driving the price higher even while cash flow declined. Business owners can make money two ways – collecting the free cash flow (running the store) or selling the whole business at a higher price. Irrational markets have become more irrational, but this madness does not negate the laws of valuation and returns. Somewhere along the line, McDonald's and most other stocks will have to decline precipitously to attract value investors after the speculators are fully allocated to equities. There are only so many investors willing to accept such low future returns on stocks. My gut tells me they are not thinking about the long-term cash flows, they are merely chasing performance and hoping to sell to someone else at a higher price. US stocks are recklessly hurtling towards the day when speculators and passive investors are fully allocated, and the marginal buyer of equities will be fundamentally-focused.

Speculators drove the price of McDonald's up 50% in 2017 while cash flow declined, meanwhile, Frank Value Fund portfolio holding Liberty Tax increased its free cash flow 8% yet the price declined 20%. The reason value investing works in the long-term is it often experiences periods where it actively harms portfolio returns. Otherwise, if it were as easy as buying companies with improving fundamentals at bargain prices, superior returns would have long ago been competed away by cutthroat market participants. Instead, value investing occasionally goes out of favor, and hordes of investors and stalwart practitioners abandon value. This is one of the numerous reasons why we can find a few cheap stocks in the most expensive US market in history. Liberty Tax now has over a 10% FCF/EV yield, meaning if the company does not grow, we receive full payback in 10 years. Happily, this 40-year advantage over McDonald's is even more in our favor as holders of Liberty Tax stock, because Liberty is a much smaller company with far fewer offices than its largest competitor H&R Block. Liberty can triple the number of offices it has (and triple its cash flow) over the long-term – something the market-saturated McDonald's cannot accomplish. As owners of Liberty Tax, we will see payback in less than 10 years thanks to the potential growth – without relying on a price-insensitive buyer to bail us out.

Speculators can make money too, but they cannot all sell at the top. Paper profits are not realized gains. As great as a 50% return on McDonald's is, causing $10,000 to be worth $15,000, to get back to its median 10-year high valuation (it is currently well above historical levels,) McDonald's stock must decline 50% from here. That makes your $15,000 worth $7,500, eliminating all the gains in the speculative frenzy as well as 25% of your initial investment. Keep in mind a 50% decline would only put McDonald's in line with its highest median valuation levels! We are focused on avoiding these massive potential losses, as well as counting the free cash flow piling up in our portfolio companies. The rest is noise, but instead of an obvious cacophony, the low-volatility market returns have morphed into a melodious siren's song, igniting the Fear Of Missing Out (FOMO) in investors' brains. Greed is one of the worst emotions for securing superior long-term returns, and we see nothing but greed out there today. Could McDonald's stock rise more, creating a 1% free cash flow yield? Without a doubt. But that would make the fall back to an acceptable level of return even greater. Bubbles go on far longer than the rational investor can imagine, and then correct far faster than expectations. The moment the marginal buyer is price-sensitive, these hyper-valued stocks will plummet. Once passive and other fundamental-agnostic investors have their highest acceptable allocations to stocks, is it hard to imagine most of the volume coming from buyers looking for much better valuations? At this point in the cycle you either drink the Kool-Aid or abandon the cult. The gap in between is what we seek to avoid.

As an aside on taxes, McDonald's has recently had a 33% tax rate and paid around $2 billion in taxes per year. Assuming the rates permanently decline to 21%, this should result in an additional $800 million in annual free cash flow assuming all fast food companies keep the tax benefit to themselves rather than lower prices for the consumer. This moves the FCF/EV yield to 2.5%, the payback period to around 40 years, but still requires a 42% decline to revisit its most expensive median valuation level in history. Valuations are so extreme in 2018 that even tax reform has little effect on long-term risk. Most large companies enjoy far lower rates than McDonald's and will not experience a potential bump in free cash flow. On the other hand, Liberty Tax earns 100% of its income inside the United States, and free cash flow will increase materially from tax reform, putting our payback period into the single digits. Finally, about 30% of small stocks in the Russell 2000 do not earn profits at all and will not benefit whatsoever from tax reform.

Our brand of absolute value investing is certainly being tested, but looking at the numbers always helps us grit our teeth and hang on to our strategy. With most US stock buyers are at or near their highest percentage allocations in history, and with global Central Banks looking to increase rates and slow or stop Quantitative Easing, we believe the turning point is fast approaching. Even if the bull market continues to elongate, the opportunity cost for waiting is decreasing because we are receiving materially higher rates on our cash than in past years. By preserving capital and keeping our cash highly liquid, we will be one of the few available bids for US stocks when seemingly everyone else is fully invested.

Thank you for your investments.

Sincerely,

Brian Frank

Frank Value Fund Lead Portfolio Manager

Performance as of 12/31/17	Average Annualized Total Returns						Total Return
	1 Yr. %	3 Yr. %	5 Yr. %	7 Yr. %	10 Yr. %	Since 7/21/04 %	Since 7/21/04 %
Investor Class (FRNKX)	(-2.81)	(-1.90)	6.64	7.17	4.92	6.37	129.41
Class C (FNKCX)	(-3.47)	(-2.61)	5.87	6.40	4.17*	5.62*	
Institutional Class (FNKIX)	(-2.56)	(-1.65)	6.94	7.44	5.17*	6.62*	
S&P 500 Total Return	21.83	11.40	15.78	13.75	8.49	9.04	220.38

* Represents an estimate based on the performance of the fund's oldest share class, adjusted for fees.

1 - http://www.cnbc.com/2017/03/31/stocks-had-a-solid-first-quarter-thanks-to-record-flows-into-etfs.html

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