OTSI KETA QUARTERLY

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OTSI KETA CAPITAL

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Otsi Keta Quarterly is designed to share insight on both current performance and future potential.

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QUESTIONS...

Contact us at:

312.473.3982
888.563.7349

F. William Schwarz, III
bill@otsiketacapital.com

Frederick P. Rollins, Jr.
fred@otsiketacapital.com

STOCKTON, CYPRESS AND THE NATURE OF RISK

The end of the first quarter brought with it two Shakespearean calamities that got our attention. As you know, it takes something special to get us to pause from our company-specific research. In this case, it was a small island nation off the coast of Turkey and a municipality 80 miles north of San Francisco. The places have more in common than good weather; specifically, a large number of unhappy people and an unclear future. While places with unhappy people and unclear futures aren't in short supply these days, few get us thinking about the nature of risk.

For those not acquainted with the recent happenings in Cypress and Stockton, the CliffsNote version is as follows:

Cypress

Cypress is an offshore financial center, dominated by two large banks with assets multiple times greater than the country's GDP. Cypress banks, not known for asking lots of questions around sources of funds, attracted deposits from businesses and individuals looking for a place to park funds outside of their home countries. The island's small population, limited natural resources and lack of industry kept commercial loan demand rather low. With lots of low-yielding deposits and minimal traditional loan demand, the Cypriot banks bought higher yielding Greek debt and other sovereign bonds, etc. When the financial crisis hits, the Greek paper becomes worthless and the banks become in need of rescue. Recently, the government approved measures that potentially confiscate 60% of large account holders' deposits with no recourse. The current estimate has depositors losing about five billion Euros.

Stockton, CA

Stockton is a port and agricultural community of 300,000 residents in northern California. It experienced significant population growth during the real estate boom. As property values rose and its tax base increased, Stockton negotiated lucrative benefit packages with its municipal unions and borrowed heavily to buy and renovate a new administration building. We have seen pictures—it is really, really, nice. When the bubble burst in 2008, foreclosures boomed, and the city's tax base decreased about 70%. With revenues falling, the unions were not as accommodating in rolling back benefit packages. Particularly since the packages included free health care for life plus one dependent, in some cases even if you only worked for the city for one month. True story. Earlier this month, the city filed for Chapter 9 bankruptcy with debts and liabilities exceeding $1 billion.

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...Stockton, Cypress and the Nature of Risk continued from page 1

You could argue that both of these situations were the result of bad management, bad business models, corruption, blatant self-interest and greed. We would agree. However, a case could also be made that many of the participants hurt the most were attempting to avoid risk.

The savers in the Cypriot banks were earning near zero yields on the seized deposits. Depositors clearly thought there was no risk from the bank, as they were demanding no yields for compensation. Depositors forgot that from the banks' perspectives, their accounts were liabilities, not assets. When the Cypriot banks got in trouble, they did not stop customers from sending in loan payments (loans are assets); they stopped letting customers withdrawal their money. We guess they figured the best way to stop a run on the bank was to take the depositor's money before the depositor could.

The Stockton municipal workers who are going to lose retirement benefits have some similarities with the large bank depositors in Cypress. They, too, thought there was no risk to their future benefits. For workers who began their municipal careers years ago, many chose them because they were more stable and offered good, not lavish, benefits. The recent contracts, including outrageous benefits by today's standards, completely changed the risk profile. It is clear today that Stockton's bondholders and post-retirement benefits are liabilities to Stockton that are certain to get reduced. The fights will no doubt center on who should take the hit—retirees or bondholders. Our guess is that they both will take a hit, and the taxpayers will bolt from the community.

So, is the moral of the story never put your savings in a foreign bank, work for the government or invest in municipal bonds? No. The calamities above remind us that real world, counter-party risks exist and are often mispriced. The nature of risk is that it lives and breathes in the future, but has to be priced today. For example, Stockton's municipal workers pushed for generous contracts that weakened the sustainability of their community. Ideally, you want to strengthen the host your survival depends on, not kill it. Cyprus and Stockton remind us that counter-party risk can undo in a moment what you thought was a hard-won victory. What makes counter-party risk so devastating is that it turns winners into losers without creating a new winner.

Below are three telltale signs of counter-party risk, and where it might show up next.

THREE SIGNS OF REAL-WORLD COUNTER-PARTY RISK

1. Ability of one party to push 100% of future risk to a second party
2. Loss of alignment between prime movers in a multi-period transaction
3. Passage of time weakens the other party

Other apparent winners that could lose when their counter party stops honoring the deal:

Apparent Winner	Counter Party	Observations
Teachers Unions	Schools/students	Contracts guaranteeing lifetime employment that are discounted from student performance weaken schools, causing schools to close.
Ethanol Producers	Refiners/drivers	Ethanol producers getting credits to produce and buyers are given mandates to purchase, yet drivers get a less efficient fuel.
CEO Compensation Plans	Shareholders	Pay-for-failure contracts and dilutive option grants that create "I win, you lose" payoffs for shareholders eventually cause shareholders to leave.

The only risk-free transaction we know of is a Treasury bill, and that only works because the Treasury has a printing press. Equities have always made sense to us because we are aligned with the company or counter-party. We always ask ourselves, "Are we invested in an enterprise that is getting stronger or weaker?" It was clear, well in advance of Cypress seizing deposits and Stockton declaring bankruptcy, the institutions were getting weaker.

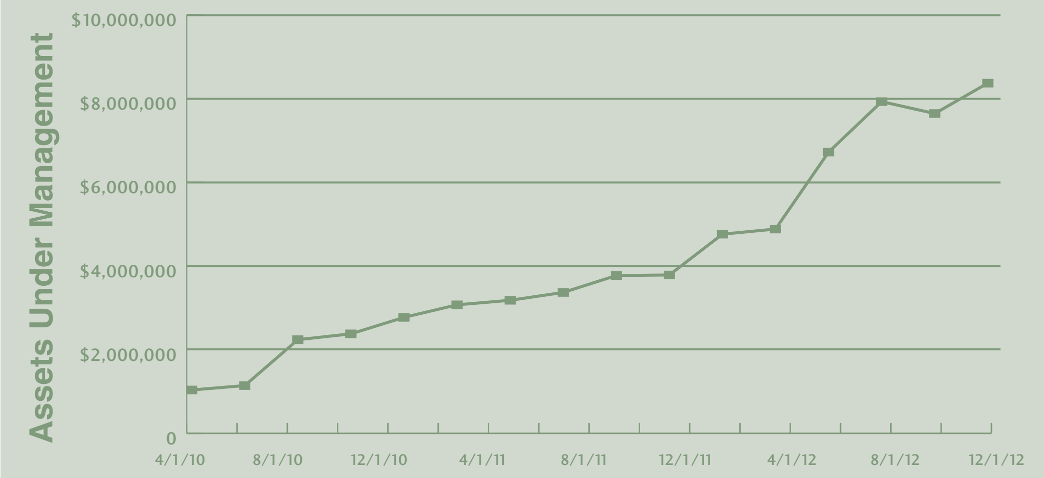
In a side note, it is worth mentioning that one asset class in the US has been getting fundamentally stronger (earnings, cash flow, cash balances)—equities. Funny, all the money keeps flowing into bonds—people keep telling us they are less risky than stocks. Conventional wisdom—ugh.

ASSETS UNDER MANAGEMENT

Since May 7, 2010, there have been some interesting developments within Otsi Keta Focus Fund Limited Partnership that bear repeating.

- July 2010: Virtual Radiologic, an original core holding of the Fund completes its merger with Providence Equity Partners.
- July 2010: American Italian Pasta Company, an original core holding of the Fund completes its merger with Ralston Corporation.
- February 2012: Cabot Microelectronics completes its recapitalization of the company with a $15 dividend and large stock repurchase program.
- January 2013: Young Innovations completes merger with private equity firm Linden Capital Partners.

We are proud today not only of our performance, but of our continued ability to bring new partners into the Partnership. As we approach our three-year anniversary in May 2013, we will continue to pursue our near-term goal of $20 million under management. Of course, our continued goal of outperformance and superior research will not waiver.



OUR RETURN ON EQUITY

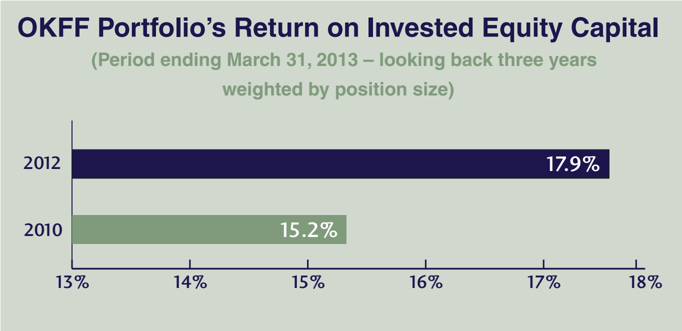
Like many equity investors, we use metrics and ratios to help us screen, as well as evaluate our investments. While no single ratio can answer every question, ROE is one of our favorites. Measures like ROE can keep us focused on a company's changing fundamentals as opposed to the most recent blip on a ticker tape. We use ROE to help us assess three things:

1. Is the business generating acceptable return on invested equity capital?
2. Are the business' returns on equity improving or weakening?
3. What is driving the changes?

What is Return on Equity?

The term return on equity (ROE) measures the amount of profit that a company generates through the use of shareholder' equity. ROE measures management's ability to perform in areas of profitability, asset management and financial leverage. It is calculated by dividing net income by average common shareholders equity.

ROE = Net Income/Average Common Equity



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OUR PERFORMANCE

For the first quarter ended March 31, 2013, the Otsi Keta Focus Fund was up 7.18%. Since inception, the Fund has returned 35.10%. All of the Otsi Keta Focus Fund numbers mentioned are net of all fees and expenses. Please see the table below to review the performance of Otsi Keta Focus Fund Limited Partnership.

Two Thousand Thirteen has started out on an interesting note. There have been many factors at work, both domestically and globally, that have influenced the market this year. It continues to prove that you cannot judge the race by who is leading on the first lap. We still believe at this stage that 2013 will end up being a good year for equities, and the Fund will perform accordingly.

Fund Name	Morningstar Rating	ROR 1ST Quarter 2013	ROR YTD March 31, 2013	ROR From Inception (May 7, 2010)
Otsi Keta Focus Fund Limited Partnership*	**N/A**	**7.18%**	**7.18%**	**35.10%**
Royce Special Equity (RYSEX)	4 star	8.66%	8.66%	41.82%
Buffalo Small Cap (BUFSX)	4 star	9.80%	9.80%	33.95%
Russell 2000 Index	N/A	12.03%	12.03%	41.54%
Russell 2000 Value	N/A	11.11%	11.11%	32.56%

Source: Morningstar, Otsi Keta Capital

**Note: OKFF performance data is shown net of all fees and expenses.*

...Our Return on Equity continued from page 3

ROE is stated in percentages and represents the yield a management team is earning on the business' equity. It is generally accepted that a company with a higher ROE is a better investment than one with a lower ROE, since it has a stronger ability to generate cash flows internally; however, this is not completely accurate. Some firms that have lower asset requirements may have sky high ROE, but the risk of them continuing to maintain that ROE is not very high as the market for their offering will invite many competitors. Conversely, there are many industries that rely heavily on large capital expenditures to get their business off the ground; transportation, oil and gas companies and utilities come to mind. These firms will have less competition due to the high start-up costs. The underlying theme is to understand the sector or sectors you are evaluating and the economic moats that surround or don't surround the businesses.

We calculate ROE using the DuPont Formula. It is a clever way to understand what drives increases and decreases of ROE for companies in the portfolio.

DuPont Formula ROE = (Profitability) x (Asset Turnover) x (Equity Multiplier)

In the chart below you can see that the bulk of the improvement in our portfolio company's ROE has been driven by better asset management and improved profitability.

We believe the companies in our portfolio are generating returns on equity well in excess of their cost of equity and accomplishing it with very modest leverage. In any given period, company returns and stock returns can vary significantly, but over time, the market usually rewards good company performance, and it gets reflected in the share prices.

	Profitability (Net income/Sales)	Asset Turnover (Sales/Assets)	Equity Multiplier (Assets/Equity)
2010 Portfolio ROE	7.9%	1.29	1.5
2012 Portfolio ROE	8.1%	1.39	1.6
Improvement from 2010 to 2012	3.0%	9.0%	6.0%

Otsi Keta Capital, LLC
500 N. Michigan Avenue
Suite 300
Chicago, IL 60611

888.563.7349
312.473.3982

F. William Schwarz, III
Partner
direct: 810.247.3133
bill@otsiketacapital.com

Frederick P. Rollins, Jr.
Partner
direct: 810.357.8566
fred@otsiketacapital.com

OTSI KETA CAPITAL