

Comus Investment, LLC

Dear Partners,

June 30th, 2019

In the second quarter of 2019 our investments experienced a total return of -0.39% before fees and -1.02% after fees, versus 4.30% for the S&P 500 index. Year to date, we have generated a total return of 5.39% before fees and 4.13% after fees, versus 18.54% for the S&P 500 index.

U.S. equities markets have recently benefited dramatically as investors have realized that interest rates will not be raised anytime soon, and so every asset is worth more to them- they are happy to realize lower future returns given their near-zero cost of money, and so all stocks have been priced higher. Most randomly selected portfolios of U.S. stocks are up double digits year-to-date and stock prices are rising frantically in short order since long-term returns can be lower. I suspect this paradox will catch many off guard in future years and is exactly the opposite of what they should want to happen, particularly for young investors with a lifetime of deposits ahead of them. It is also the exact opposite of what we do- they are lowering their cost of money to pay full price for every asset at a very low future expectation, while we have a high cost of money and keep it stable regardless of fixed-income rates and as a result only invest in stocks which meet my criteria. I require attractive absolute returns for us regardless of what any other asset is expected to return- if over 5+ years, some benchmark delivers 4% a year and we deliver 8%, I would find that to be poor performance on our part.

As our results from the past year have shown, we are vulnerable to the short-termism of most international investors and have experienced underperformance relative to the U.S. due to temporary and substantial flows of funds out of our region and into the overcrowded U.S. market. I do not know how long this will last, whether it continues into a full-on melt-up, or when our actual and expected returns will align, but it is typical in a bull market for multiple expansion in popular stocks to produce temporary outperformance relative to cheap and unfavored investments with better long-term expected returns. This is why Buffett references emotional tolerance as a limiting factor for most investors, as outperformance generally requires periods in which flows of funds are moving against you- in fact this must generally be the case in order to find opportunity and it will often cause short-term discomfort.

Investing is about buying as much as you can, in terms of assets and earnings, with every dollar you currently own- everything else is a detail towards accomplishing that goal. Every investment decision is therefore made with the belief and confidence that we are getting significantly more than a dollar in real business value for each dollar we spend on stocks- the question is whether we are getting the most we can for our money at any given time.

As it currently stands, the average company we own trades at around half of my estimated liquidation value of each, at around 15x historical earnings, and has 104% of its current price in net cash and securities, meaning that for each dollar invested we are immediately receiving \$1.04 in liquid assets (nearly all of which is cash). Given that my estimates of liquidation value often require substantial markdowns from net-asset value, most of the companies we own trade at fractions of stated book value. While the earnings multiple may not seem very attractive, using

earnings from recent years would give us around a 10x P/E and I expect average earnings to continue to grow in the future. These figures take the average across our entire portfolio and don't account for the fact that we are invested most heavily in those with substantial earnings relative to price and at the highest discounts to net asset value, which would improve our average figures quite a bit. Most of the companies we own generate poor returns on capital, although netting out cash and investments, it is around 8%. With the exception of bank stocks, a company without any debt generating high single-digit returns on capital and growing at a reasonable rate would sell for at least 2x net worth in the U.S., and in fact it is quite rare to find profitable companies with average future prospects selling for less- most of them will be levered, expected to generate losses in the future, and/or highly cyclical.

It would likely seem strange to you, if after purchasing a local business for \$1m that generates \$100k in annual profits, the former owner wrote you a check for \$1.04m. When a shareholder sells their stake in a company at this price, they are effectively saying (whether they know it or not) that the firm will never generate a profit again and that the remaining net assets of the firm are worth less than nothing. They are in fact paying others to take the company off their hands. In a reasonably efficient market, this would only be a logical price to sell at under one or more of the following circumstances:

- a) The company is generating large losses, or is expected to generate losses in the near future (investing in those which look cheap but will deteriorate in the near future is how you get 'value traps')
- b) The company requires substantial capital expenditures in the near future to maintain profitability
- c) The company has a large and unsustainable working capital deficit, and cash will be used in the near future to either reduce short-term payables or increase inventory balances
- d) The company has substantial hidden or off-balance sheet liabilities, the most common of which are VIE/SPE liabilities, underfunded pension liabilities, lawsuits, lease or other non-cancellable obligations, etc.
- e) The company's investment securities make up a significant percentage of the firm's liquid assets and have experienced a large unrealized loss which hasn't yet been marked-to-market on the books
- f) The company is fraudulent or likely fraudulent, so that the financials cannot be trusted (there are often obvious warning signs such as share issuances, taking on debt, ownership via obscure webbed holding company structures and questionable related party-transactions and such issues are mainly prevalent in a few countries we tend to avoid)
- g) The company has management who are unethical and will likely steal and/or siphon funds off in ways that benefit them personally
- h) The company has management who are very poor allocators of capital, and they will likely waste cash/earnings generated or invest it in non-liquid and rapidly depreciating assets likely to generate very low returns (they will turn \$1 into substantially less than \$1 of present value, although this is often tough to do without generating losses)

I'm sure there are more, but those are the main ones that come to mind. The companies we own don't exhibit those issues, and we are invested in the regions and space that we are because the market is consistently asleep at the wheel. The fact that prices can remain so illogical for long periods of time is great for us, and is exactly why I am attracted to this space, but it makes short-term performance difficult to assess as well as irrelevant.

The ability to invest small sums and purchase fractional ownership of companies in unfollowed markets brings us significant benefits that we otherwise wouldn't have. If we attempted to purchase all of the outstanding shares of the companies we own through a tender offer or formal merger proposition at their current prices or at a slight premium, we would frankly be laughed at. The board of directors would say we are offering an entirely unreasonable price and then have a third-party valuation firm value their stake at 2-3x its current price. I know this because it has happened in the past for some of the companies we currently own when others have attempted it, and the valuations the third party firm has come back with are pretty close to what I would expect, and I'm often more conservative than they are with my estimates. With our current AUM however, we can buy as much as we like at such prices without limitation.

I focus on and direct our funds towards international small-caps because that is where most of the opportunity is, for a few reasons. Western investors, particularly those in the U.S., are prone to look only within their home country and are reluctant to invest abroad. Most sophisticated firms and institutional investors can't invest in companies under \$1bn in market cap given their AUM and the limits it places on their opportunity size- so while most firms will avoid investing internationally, they are also structurally restrained from bidding prices up in the small-cap arena. Most retail investors opportunistic enough to attempt to enter this space will know just enough to be a danger to themselves, and don't have the volume to meaningfully affect prices. While there are other small funds who could potentially enter our space, few of them would like to invest in small and average/mediocre companies in other countries, the combination of which would make them feel extremely uncomfortable and I believe prone to making mistakes.

Most of the companies we own are quite old and have been doing the same thing for decades, with only one company born after the turn of the century and most long before. We own one which is over 100 years old, and it is understandable that people wouldn't be interested in a century old firm which is still a small-cap when there are much more exciting and innovative companies out there. The equity of the firms we own has been built up over a long time period and most of them are destined to remain small. Demand for these stocks is low and as a result it would be difficult for most funds to advertise them and gather AUM based on investing in them.

Further, few firms have clients which will understand and be willing to accept differences in temporary performance relative to the most popular and best-performing investments at the moment to seek long-term outperformance. The vast majority of investment funds have to report on a monthly basis, as that is the time period by which investors would like to hear about their holdings and current developments (most institutional investors would find it crazy to hear about performance only once a year or even quarterly)- while they measure by the month, quarter and year, we retain a significant advantage by thinking over a period of 3-5 years and appreciating price declines regardless of how it affects our short-term numbers. Paradoxically, this gives us

the opportunity to do better on average than they could. As you all know, the only reason I write quarterly letters is because as the manager of an RIA firm I am required to. For all the above reasons, there is substantial opportunity abroad up to \$1bn (above \$1bn there are quite a few but not as cheap) and as long as this remains true, this is where I will direct our focus.

What matters isn't how the die lands in any given year, or I suppose month or quarter using typical institutional measures, but that the die is loaded in your favor. As long as the expected outcome is favorable, the more times you roll it, the better you will do. Like everyone else, we will roll ones and twos (and sometimes we will roll a 2 when the market rolls a 6), but if I am loading the die properly then also more fours to sixes than average. The difference between short-term actual and long-term expected returns over many iterations is what makes assessment of any fund manager difficult. I expect actual and expected outcomes to differ, often quite substantially over shorter periods of time and this is exactly why we are actively investing. When I invest our funds, the only thing that matters to me is the average expected returns of the investments purchased, so regardless of actual performance I view every dollar invested as having created potential future profits- which is why I almost never have much cash, I view it as a massive cost. These potential profits of course must translate into real profits in a reasonable period of time, as I believe they will. Given the stability of our underlying companies, any future drop in prices increases our potential profitability and returns, which further increases the incentive to invest and again, all of these things lead me to care very little about our mark-to-market performance over a year or two (one or two rolls of the die).

Economic history has shown that things get weird when the cost of money is zero for prolonged periods of time. Real interest rates and economic growth are correlated, and so most developed nations have near-zero interest rates given their likely low-growth. The only countries that can bear higher rates are rapidly growing and/or developing, the most prominent examples being China and India. Studies indicate that when rates are so low, it hinders efficiency given that any asset is worth purchasing relative to fixed-income and low-interest rates tend to beget low-interest rates as productivity and efficiency drop, reducing economic growth. It generally also comes with increases in debt issuance and increasingly risky behavior on the part of both corporates and speculators. Any corporate project that won't generate losses has an attractive IRR when compared to fixed-income, and so everything becomes an attractive investment regardless of how low the incremental profits are relative to invested capital. There are more than a few case studies of countries running into trouble under such conditions, and while nobody truly knows the end-result, it should be seen as a negative. While rates remain near-zero, and as global economic growth remains low, it is plausible that asset prices could remain high for longer than expected- if all equity investors are fine with a low return then that is what they will inevitably receive.

Best,

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