Comus Investment, LLC

Dear Partners,

January 1st, 2020

In the fourth quarter of 2019 our investments experienced a total return of 7.97% before fees and 7.34% after fees, versus 9.06% for the S&P 500 index. For the year of 2019, we generated a total return of 11.17% before fees and 8.65% after fees, versus 31.48% for the S&P 500 index. At this point you will have received reports with the details on your balance, fees, holdings, and performance from InteractiveBrokers for the past quarter and full year.

2019 was an extraordinary year for developed equities markets, with most U.S. indices posting their best performance since 2013. Last year, most indices marked losses as a result of rising trade tensions, an increasing fed funds rate, and a decreasing Fed portfolio. This year, particularly in the latter half, there has been optimism regarding trade easement (and the benefits to aggregate demand this would bring to all countries in the global value chain), and the Fed has once again started decreasing its funds rate as well as increasing the size of its portfolio. These developments have led to significant gains across the board for both fixed-income and equities, but unsurprisingly have come primarily out of multiple expansion rather than corporate earnings growth- in fact, the earnings of the S&P 500 constituents remained approximately flat in 2019.

Though it may sound self-serving of me to say, it is clear that U.S. indices have been punching above their weight over the past decade as a result of numerous positive tailwinds. Starting from the base of the financial crisis, valuations have risen significantly, interest rates have dropped, quantitative easing has been implemented full scale, unemployment has dropped to its lowest point in fifty years, corporations have been able to lever up due to an historically low cost of debt, tax rates have been slashed, and corporate profit margins are now at cyclical highs. As a result, it is the first decade since 1850 that the U.S. has avoided recession, and the S&P 500 has averaged around 14% annual returns over the period for one of the best decades in its history. Over the decade, underlying earnings growth has averaged about 8% per year, which is remarkably high and almost certainly unsustainable; it has been boosted by many of the same factors, along with the rise of the FAAMG stocks and the secular shift towards higher margin tech firms in the index. Unless if corporate profit margins can expand indefinitely, I find it highly unlikely for corporate earnings to continue to grow at a rate markedly higher than GDP/GNP growth (which continues to average around 2% per year).

Our portfolio has experienced stagnation over the past two years- we outperformed most international indices last year, and have underperformed most this year. Though I have little evidence to support this claim, my best guess as to why we have experienced lower volatility is due to the fact that we hold relatively illiquid stocks, often with fewer speculative shareholders willing to trade on news unrelated to earnings. While negative macroeconomic sentiment may dissuade the marginal trader or international fund from making purchases, I do not think it provides insiders or value-focused investors an incentive to trade in either direction. This could explain why the stock price charts of many of the companies we own display stagnance the majority of the time, along with intermittent spikes whenever outsiders gobble up the limited

float. As a result, I expect our returns to be highly erratic and to have little correlation with many of the passive indices which comprise our benchmarks.

Some partners have asked about capital allocation in the companies we own and how it affects our returns; it seems worthwhile to quickly cover my thoughts on the topic. The first and most obvious point is that if a company is destroying value through capital expenditures that provide low or negative returns on capital, this will be factored into the valuation through a reduction in free cash flows- here a low earnings multiple provides no insight into what owners are receiving. The majority of our companies have low reinvestment ratios and attractive free cash flows- this comes with low growth, which is the preferable outcome considering their investment alternatives.

Given that frequently I make purchases on the basis of a discount to retained earnings, the payout to owners thereof comes up often in conversations about our holdings. I believe the general sentiment, and one that has been expressed publicly by many intelligent professional investors is as follows:

As a minority investor purchasing a company at a discount to net asset value, you have no influence in affecting business affairs or payout policy. If there is an incentive for management to maintain the status quo or hoard, and if management refuses to liquidate or pay out excess cash/other assets when it has no reasonable reinvestment opportunities, then there is little reason to purchase the stock since dividends won't be paid and cash will languish indefinitely on the balance sheet. The investor should therefore adjust the valuation for the expected delay in payout and avoid such value traps, which are frequently fool's gold.

This initially appears to be an enticing argument, for if we are focused on business value to a private owner, the timing of dividend payments will be crucial in order to maximize our returns. There are however, numerous issues with the mindset expressed above which lead to absurdities in public stock valuation if practiced by all investors.

The primary issue is that the investor would disregard when earnings are generated and discount cash held until it is paid out. If a company decides to pay out all cash five years from now, this would place the same value on earnings in year two as those in year four. To the extent the assumptions regarding payout timing are correct, the valuation is mathematically verifiable if the investor wants a certain rate of return, but it will value cash at a fraction of face value. For example, if our required return is 10% and the company will pay out next year's earnings in a decade, we would value that cash at 39% of its face value given our delay in its receipt. Further, how would we go about valuing a low-growth company with no intention of paying a dividend in the near future? Many would find it uninvestable and deem it worthless, at least to them- is there no price at which it becomes an attractive bet?

The problem here is that we would discount cash, which is often a riskless asset, at an equity rate of return. If the market as a whole did this in response to the anemic capital allocation policy of some company (using the logic that the cash somehow depreciates given the investor's required return), it would likely leave a free lunch available to any potential acquirer and those minority investors willing to hold despite the company's flaws.

Such a valuation would imply that all conditions will remain constant regardless of the public quotation placed on the business. The stock market however, does not operate in a ceteris paribus state. Of course, the likelihood of an activist shake-up or payout increases as the valuation drops to such lowly levels. Further, management can at any point publicly discuss the potential for a payout which would bring the stock price much closer to fair value; in most cases the payout wouldn't be necessary. Mergers also occur with some regularity in highly depressed stocks and are usually negotiated between boards on an arms-length basis, making it unlikely that a transaction would occur at a price below the target's working capital balance. Assuming management are not completely entrenched and enriching themselves at their owner's expense (in which case it is true that the valuation matters little), many good things can happen.

Though I'm not a mechanical investor, they often have the upper hand in this regard, as they don't need to grapple with the likelihood of such events occurring- if you hold enough companies trading at unreasonable prices, it is difficult to do poorly. It is often impossible to predict a catalyst, and in my experience, stock prices often change dramatically without any significant news. It is also to their advantage that they are willing to accept 'value traps'- that is, a stock which is remarkably cheap but which may not appreciate in their holding period (not the type that rapidly declines due to diminishing results). Even if the majority of picks do not work out to fair value, the average result is likely to be worthwhile. To summarize, I personally would prefer to deal with poor capital allocation and wild valuations rather than good capital allocation and fair valuations.

Moreover, I contend that the vast majority of value traps are to be found in the high-growth arena, where investors pay elevated multiples for the hope of attractive earnings decades from now. Whenever growth rates fail to meet expectations for high flyers, valuations are slashed and investors suffer losses. With a minority of these chosen growth stocks ever meeting expectations, it should be clear that even high quality companies can be sinister value traps. Even if growth expectations are met, there is no assurance that higher future earnings will translate to higher dividend payments to owners; quite a few examples exist of equity built up over the years being wasted as corporate maturity comes along. It should be clear to the intelligent observer that the purchase of quality (however that should be defined) provides no safety from the risk of error in the estimation of future business results and/or investment losses, though it will make investors feel comfortable the majority of the time.

As always, feel free to contact me at any time with questions, comments or concerns.

Best,

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