

Comus Investment, LLC

Dear Partners,

April 1st, 2017

As you know, 2016 was our first year of operations. Our investments increased in market value 42.6% before fees and 40.1% after fees, versus 16% for the S&P 500 index. Our 2016 year ran from March 31st, 2016 – April 1st 2017. Going forward, our fiscal years will align with the calendar year, which means that the first quarter of 2017 (January 1st, 2017 – March 31st, 2017) will be included in both our 2016 and 2017 results. In the first quarter of 2017, we generated a total return of 10.49% before fees and 9.86% after fees, versus 6.07% for the S&P 500 index.

Unfortunately, I must charge most of our clients a fee based on assets under management rather than a performance-based fee. There is legislation barring advisors from offering a performance fee unless your net worth excluding first residence is above \$2.1 million, or if you are a foreign investor. A reasonable performance fee would charge approximately 20% of all profits generated, and I will use that as a benchmark. With a total return of 42.6% for 2016, and with a performance fee of 20%, our clients would have paid 8.52% of their assets under management ($42.6\% \times 20\%$). If you are being charged our 2.52% annual fee, then you have benefited greatly this year. If you have any questions about this, or anything else I will say in this letter, please contact me- I am always open and happy to speaking with partners.

Before describing our results, I would like to briefly summarize our investment operation and what I do.

I view all of you not merely as clients, but as partners. We all own the same businesses and are therefore collective owners and partners in these companies. As a result, we will all experience similar performance in our investments. In these letters I may use the terms ‘we’ and ‘our’ often, but since I decide what we own, I will accept full responsibility for our results- good or bad.

It is my job to find public companies which sell on stock exchanges for less than what they are truly worth. In purchasing the stock of undervalued companies, it is my belief that we will achieve satisfactory returns. I cannot guarantee results, but it is a method which has worked in the past for many successful investors. The idea is that by purchasing \$1 for \$0.50, we will do well in the long-run. I take advantage of price fluctuations of stocks to buy them at a discount. In general, it is a good thing for us if stock prices decline, as we can then buy them at lower prices. It is my belief that stock prices only indicate the supply and demand of a stock- so if demand for stocks declines (as in a recession), then stock prices will decline. Of course, this does not mean that the value of those companies has necessarily declined. This disconnect between ‘intrinsic’ values and stock prices is what allows us to take advantage of ‘value’ in the market- situations where stock prices are significantly lower than stock values.

I am reluctant to associate myself with this person, but I would like to present a great quote from a popular television show (Game of Thrones) which sums up the ethos of this firm quite nicely:

“Chaos is a ladder” – Lord Petyr Baelish, aka Littlefinger

Chaos, confusion, volatility, and fear in public equity markets are our allies in seeking undervalued companies. Although all market participants can benefit from investing in the long-run, in the short-run it is a zero-sum game in which your loss is my gain. For us to purchase undervalued stocks, others must be willing to sell them to us at irrationally low prices. Our firm is named after the Greek god Comus, one of the sons of Dionysus and a god of anarchy, chaos, and excess. To achieve returns above those of the market in the long-run, we must embrace chaos and volatility and use both to our advantage.

Although we benefit from chaos, our investment process is anything but. I am extremely selective and conservative in our investments, and will not make any investment without significant thought and a high level of confidence that what we have purchased is significantly undervalued and has a large margin of safety between the price we paid and its intrinsic value. I will not allocate a single dollar of our wealth to an investment I am not confident in. In my opinion, this aggressive conservatism allows for both high returns and low risk, given that we are purchasing companies at prices far less than what they are worth. By low risk, I mean a low chance of permanent loss, not low volatility.

I separate the two types of companies we will own into general groups- 'good' companies and 'cheap' companies. In both cases, we will only make purchases when I believe the intrinsic value of the company is far above the current market price. Good companies are those which will earn more in the future than they do now and they offer a product/service that cannot be replicated by competitors. They generally exhibit high returns on invested capital and have significant prospects for future growth. When purchased, we will own good companies for very long periods of time, if not permanently. It is of course difficult to find companies with such qualities at low prices, and so the majority of our investments will generally be in cheap companies.

Cheap companies are those which may be dramatically underpriced relative to the assets they own, or the earnings and cash flows they generate- hopefully both. We will sell these when they experience a price increase to fair value. I expect these price reversions to fair value to happen within a few years of purchase for most cheap companies, but not all work out. Warren Buffett called such an operation of rotating cheap companies the cigar butt strategy. They should be purchased when they are cheap and sold when they reach fair value- there is only one puff in the cigar and thereafter the investor must move on. They do not exhibit strong earnings growth and generally have no advantage relative to their competitors and so will not compound their intrinsic value over time as a good company would.

Since 2009, interest rates have been historically low and stocks in the U.S. have experienced a significant run-up, making the stock market historically expensive. Over the past year, the S&P 500 has delivered about a 16% return. In my opinion, the S&P 500 will certainly not continue the performance it has delivered over the past year in the long-run. For various reasons, I believe the returns of the S&P 500 over the next decade will be quite low.

The total return of any stock depends on the sum of three things: the earnings growth of the underlying business, the dividends accruing to the stock, and the change in valuation of the stock. That being said, the U.S. economy is growing at a rate of approximately 2% per annum.

As a result the earnings of the S&P 500 have also grown at about 2-3% a year over the past 10 years. The earnings of the 500 largest companies in the U.S. economy cannot grow faster than the U.S. economy over any reasonable length of time, so I expect this 2% earnings growth to remain constant. The dividend yield of the S&P 500 is currently a bit less than 2%. The valuation of the S&P 500 is at a historical high, with only 1929 and 1999 being higher, so valuations cannot continue increasing over the long-run. From 2010 to now, the S&P 500 has generated a total return of over 120%, while earnings of the underlying 500 companies have only grown by 28% or so. Investors are simply willing to pay more for those earnings, and as a result it is guaranteed they will receive lower future returns. With 2% earnings growth, a dividend yield of 2%, and valuations which cannot rationally increase, I would contend that the highest annual return one should expect from the S&P 500 over the next 10 years is around 4% or so. The historical data of S&P 500 returns at such valuations would support this thesis- you can see [here](#) for a more in-depth look at this.

It is my opinion that many market participants have moved away from business valuations and are now acting upon price fluctuations. To be an investor you must be tethered to intrinsic valuations in order to make wise investment decisions; if you are acting upon changes in stock prices you are merely a speculator and will act in an irrational, emotional, and lemming-like fashion in times of volatility and crisis. For this reason, whenever the next crisis occurs, I believe the majority of market participants will sell en-masse as is usually the case, leaving opportunity for those of us ready to take it.

These high market valuations have made it quite difficult to find undervalued companies in the U.S., which is the reason the majority of our investments are currently found internationally. Most of the companies we own are located in foreign, but highly developed nations similar to ours.

Since the majority of our investments are in cheap companies, I will briefly describe some of the methods by which I analyze such companies. In many cases, they are cheap relative to the present value of future free cash flows, but in some cases they are not and may not generate substantial earnings. Along with earnings, I also estimate the market value of equity of many of these firms. In most cases, the book value of equity is a highly deceptive figure as it is written at cost. To determine whether the firm may be cheap relative to the assets it currently owns, I estimate the market value of that equity- this is my estimate of what the firm would receive in cash if it were to sell off its assets and pay off all liabilities. If a company is cheap based on earnings/free cash flows, a conservative estimate of the market value of equity, or both, it is likely a bargain. A few quick examples of such investments that have worked out for us in the past year are presented below:

We purchased stock of a company called Osaki Engineering for around ¥375 per share on March 31, 2016. Osaki Engineering had historically been a loss-making company, but owned a significant amount of assets. It owned ¥278 per share of cash and ¥650 per share of receivables and inventory, and also had a significant fixed asset position, with only ¥133 of total liabilities per share. My estimate of the equity value of the company was around ¥800 per share. In May of

2016, the company was acquired at exactly ¥800/share, providing us with a return of 113%, at which point I sold the stock.

In April 2016, I purchased stock of a company called Tokyo Radiator Manufacturing Co. for ¥409 per share. The company had a stable annual profit of about ¥90 per share. It also had a significant asset position, with cash and investments of ¥837 per share, receivables of ¥577 per share, inventory of ¥144 per share, long-term marketable securities of ¥70 per share, and fixed assets of ¥500 per share, with liabilities of ¥743 per share. With much of its equity value held in liquid assets, I estimated an equity value of, once again, around ¥800 per share. I sold it for ¥761 per share in November 2016, for a total return of 86%.

In August of 2016, I purchased stock of a media and advertising company called Hiraga Co. for ¥316/share. It was making an annual profit per share of about ¥80. It had stable earnings and a business with average future prospects, making it worth significantly more than ¥316/share. I sold it for ¥444 per share in March of 2017, for a 41% total return.

The past three examples are of cheap companies which worked out for us. It would be redundant to describe all of them, but we have others which have not worked out yet. In any case, we hold investments which I believe should sell for far more than they currently do.

I was able to purchase stock of one good business in the past year. In 2016, airline stocks were quite cheap because Wall Street was worried about ticket pricing and competition between the airlines. It allowed me to purchase Spirit Airlines at around \$38 per share in October 2016. About two weeks after my purchase, another investment firm provided a report stating that the worries about pricing and competition were overblown. Within a few months, Wall Street came to that realization as well and the stock was selling near \$60 per share.

A quick explanation of the investment follows- all airlines offer a similar service, and so it is basically a commodity. As a result, customers mostly choose their flights based on pricing. This means that the airline with the lowest costs and prices will do extremely well. This is the case in all commodity industries- since the product cannot be differentiated, customers flock to the company with the lowest prices. Spirit has by far the lowest costs and prices in the industry, and I doubt that will change anytime soon. It has an extremely productive workforce which perform different jobs, it uses the same planes across the U.S., it flies point to point instead of using expensive hubs, it doesn't spend much on advertising, it doesn't offer any amenities without payment on the flight, etc. It would be extremely difficult for any competitor to replicate its system. It is very focused on getting people from point A to point B at the lowest price possible.

It of course, has been experiencing rapid growth in the past few years as it takes customers from other airlines and allows people to fly at low prices when they otherwise wouldn't have traveled. Spirit has issues with customer service and reliability which have been highlighted in the media in recent months, but they replaced their CEO in December of 2016 and since then, improvements have been made. It was rated the most improved airline of the year for 2016. They will need to continue their progress as they build their brand and become well known, and I expect turbulence in resolving customer service issues and pilot pay, but I plan on being an owner of the company for a long time. At \$38 per share, Spirit was trading at a price-to-earnings

(P/E) ratio of around 9. For your reference, a P/E ratio of 10 would indicate that the market believes the company will have flat earnings forever. At a P/E of 9, the market was essentially saying that they expected Spirit's earnings to decline permanently. Clearly that won't be the case, and the market was giving the company no credit for its future prospects. As a cyclical business subject to adverse market forces, owning an airline will be turbulent to say the least, but I believe in the long-run it will retain a significant cost-advantage and continue to generate industry-leading returns on capital.

Finding good companies at low prices is extremely difficult in this bull-market, and I believe it will take chaos and uncertainty to find such deals. This is why our best investments will be made in times of massive crisis, such as in a recession and significant drop in stock prices. There will be a time where general stock market prices are low, and we will be significant buyers of stocks. Until then, I will continue to find deals and put our money to productive use.

Best,

Aaron J. Saunders

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