

# Comus Investment, LLC

Dear Partners,

June 30th, 2018

In the second quarter of 2018 we experienced a total return of 2.55% before fees and 1.92% after fees, versus 3.43% for the S&P 500. Year to date, we have generated a total return of 8.66% before fees and 7.40% after fees, versus 2.56% for the S&P 500.

Given that I briefly discussed my rationale for the purchase of Spirit Airlines in our 2016 letter, I should mention it now. I recently decided to sell it, mainly because other opportunities have come up which I believe provide more immediate potential for us. Over the nearly two years we held it, the firm has continued to grow both revenue and earnings at a high rate, and it has maintained its advantage as the lowest-cost provider in the industry despite recent contract negotiations that led to significant pay raises for its employees. Its stock performance over our holding period was around 0% due to continued competition and overcapacity in the industry. My opinion on the firm hasn't changed, and if I were managing much more money with access to fewer opportunities I believe we would still own it, but it is as simple as saying that we can invest in much smaller firms with absurd valuations, and a few came up which I couldn't resist. I did not want to hold the airline through a prolonged period of industry overcapacity and price cutting that affected the stock price performance of all competitors while missing other options which I believe offer much larger discounts to fair value. Spirit comprised about 5% of our portfolio and I don't believe the non-performance of the stock over our holding period materially impacted our total results.

The following discussion will I believe, be the most nuanced and accurate representation of my investment process that I have made public to date. Unfortunately, it cannot be represented by a simple label or term and so I will have to explain details.

The value of any firm is the sum of the value of its operating assets and its net non-operating assets. Operating assets are the assets the firm uses in its operations to produce and sell goods/services. Hopefully, the firm either does or will eventually generate earnings and free cash flow from the sale of products, and so the value of operating assets are generally determined by the present value of all free cash flows they will produce for owners of the firm. This means that the investor must estimate all the free cash flows the company will ever generate from selling its products, then discount them from the future to the present at an appropriate rate (a rate of return that the owner could receive from putting their money to work somewhere else). As free cash flows measure the cash that owners have the ability to pocket, and which isn't needed to reinvest in the firm, this is basically the sum of all cash the owners will receive from the firm's ongoing operations. In simpler terms, how much cash will owners (stockholders) receive from this company continuing to do what it does?

The term net non-operating assets, as with all things in finance, is much simpler than it sounds. It is the value of assets the firm owns, which it does not need for its operations. They generally come in the form of cash and marketable securities (stocks/bonds/deposits/cash equivalents) and

are just laying around for the firm to use however they please. These non-operating assets are reduced by the firm's outstanding liabilities, those being debts it owes other parties, to determine the net amount of cash, stocks, and other non-operating assets the firm has.

This total firm value equation is displayed below.

$$\textit{Total value of firm} = \textit{Value of operating assets} + \textit{value of net non-operating assets}$$

While it is clearly desirable for the firm to generate significant cash flows from operations, this is not always the case. For some companies, they could do better by selling off their operating assets and moving on from their unprofitable operating history. This means that while they may generate negative or near 0 cash flows from operations in total, the value of their operating assets can be positive from immediate liquidation. This is not an enviable situation, but this immediate liquidation value of operating assets should be taken into account for poorly managed companies, if it is materially greater than the value of the firm continuing to operate.

A well-managed firm should have low levels of non-operating assets. Unless if it is an insurance company, a bank, or an investment company, there is no reason for a company to hold high levels of cash, stocks and bonds. Generally, if the firm has profitable and growing operations then those additional assets should be liquidated and reinvested into the firm. If the firm cannot use those assets to generate a satisfactory return from operations, then they should be granted to stockholders as dividends so owners may use the cash for other, more productive purposes. Simply, if non-operating assets are unreasonably high then the firm is not allocating its cash appropriately and is not putting it to its best use. This is something of a double-edged sword, as high levels of non-operating assets increase the value of the company, but likely indicates that the company has no means of putting those assets to use and that management likely isn't using them productively.

As an investor, by estimating the sum of the values of both operating and non-operating assets, we are looking at cash levels. Cash the firm currently has or could easily have in its non-operating assets, and cash the firm will receive in the future from its operating assets. Firms are to be seen as cash generation machines, and all assets are to be translated into current cash or future potential cash production for owners. Companies provide a product or a service, which if unique and valued by consumers, and unable to be replicated by other firms, will be in high demand. The firm's market position and operating structure will determine its cash generation ability and of course if favorable, the company will be able to generate high amounts of cash for owners.

From the simple equation outlined above, we can see that growth is implicit in firm valuation. The higher the growth of the company, the more valuable the company is, as it will generate higher cash flows in the future than it does now. This is why the term 'growth-investor' makes no sense, and is also why the term 'value-investor' is redundant and unnecessary. To be an investor, you must be focused on business value, and to determine business value you must

include the firm's growth. To split these things up as if they are different in some way would mean you do not understand valuation. The fact that these two terms are used ad-nauseam in mainstream financial media to attempt to inform investors should give us some pause, as I believe they do the exact opposite.

The mainstream idea of a 'value-investor' would be someone who looks at firms with low P/Es and low P/Bs. That is, they try to buy companies with low prices relative to current earnings, and low prices relative to the current book value/equity (assets minus liabilities, aka net worth) of a company. Neither of these ratios has the ability to accurately describe a firm's current or future results, and neither, even together, could value a firm. A firm's discount to its net worth does not help value its non-operating assets, and its discount to current earnings does not help value the sum of its future cash flows. A firm's equity is a measure of the cost of a firm's assets (assets are generally put on the balance sheet at the price at which they were paid for, not their value if sold), and does not help explain the real market value of the assets the firm owns but does not need for its operations. A firm's equity value compared to the real value of its assets can be markedly different depending on the nature of the assets and how they are written to the balance sheet and adjusted over time. Current earnings aren't indicative whatsoever of cash flows which may accrue to owners, and clearly they cannot express earnings in future years, and particularly not cash flows in future years. There are companies which may experience positive earnings indefinitely but may also never generate cash flows for their owners from operations- that is the company must always re-invest its earnings into operations to maintain its current level of earnings and so owners will never receive any cash until the firm winds down.

The preceding paragraph explains why I do not believe good opportunities can be determined using ratios or found by screeners or other programs used to group companies together by metrics. This is why nearly all the work must be done on the ground floor- each company must be looked at one by one, as this is what is required to value them. This is of course one of the many reasons why all opportunities cannot be arbitrated away- there are far too many of them and a detailed look is required of each one. When I say arbitrage, I mean the process of taking advantage of a price difference. Arbitrage generally requires a price difference of the same asset in two markets to make a riskless profit, but I mean it to show a difference in the price of a business on the stock market compared to its value in reality. The stock market of course, often does not represent reality due to innumerable inefficiencies.

I must now explain another concept and then tie it back into our original discussion to explain our investment operations in full and how I attempt to generate excess returns for us.

The total returns from holding a stock will be the sum of the earnings growth of the business, the dividends paid to the stock, and the change in valuation of the stock. If you think about it for a second, you can see that there are many ways to generate unnatural returns from focused investing. You can purchase stocks in which the underlying business is growing at a rapid pace, and where the price relative to earnings will remain constant, so that the stock price increases over time at a higher pace than that of the market. You could also attempt to purchase stocks whose mix of dividend return and earnings growth will lead you to beat the market average from an index, while its valuation remains relatively constant. Clearly from this simple and verifiable

equation, you can see why purchasing a large, slow-growing company at an average price is not desirable, no matter how great the company is- earnings growth will be low, the valuation cannot change much, and dividend yields are almost never high enough to drive above-average performance alone.

Our current holdings offer an annual dividend percentage of around 1%, and the earnings growth of the companies we own on average is quite low, so clearly neither of those factors are contributing much to our returns. In our case, we focus on the last factor to drive returns- changes in valuation. I attempt to purchase “cheap” stocks, so that the results of the underlying business are constant, but the stock experiences a dramatic change in valuation.

In purchasing stocks which will not generate returns from high earnings growth or unnaturally high dividends, we are simply waiting for other investors to realize the discount to real value of the companies we own, and bid the price of the stock up. When the stock price reaches fair value (which of course is usually a range rather than one specific price) we move on. This is why our desired holding period for most stocks is 0-3 years- the sooner the better. We wait for the pop to fair value and look for the next one.

The process of other investors realizing the undervaluation (in my opinion) of the companies we own, which leads us to potentially realize above-average returns is in my experience a matter of luck more than anything. We are obviously not advertising the companies we hold to other investors, and as a group we do not own enough to affect the stock price ourselves through activist means, but somehow and some way, many of the companies we own do not stay cheap for long. With a disappointing quarter like the one we just had, I take our returns as a matter of chance more than anything. It simply was a quarter in which others did not ‘find’ what we are looking to sell, for various reasons. Obviously long-term performance falls upon the investor and only the investor, but short-term changes in price are generally just chance and randomness. The stock market is a bidding market after all- lots of weird things happen and it is impossible to predict which parties will buy or sell their holdings in the short-run.

So in managing our combined funds, I am looking for firms which have the potential to experience a dramatic increase in valuation although business results may be average and may not change. That means they must be extraordinarily cheap relative to real value for that to happen. In analyzing companies I am not looking at just cash flows, or just assets, I am valuing the entire company and am unbiased in where the value comes from. This means that we own some companies which generate high cash flows but have low asset piles, others which may generate nothing in the way of cash flows from operations but own such a high value of assets that they are great purchases at current prices, and some with a mix of both qualities.

To do this, I look worldwide as you all know, given that stock prices in the U.S. are not favorable. I am quite picky about which foreign markets we operate in due to corporate governance issues, the potential for financial misrepresentation and other risk, but we directly own companies in highly developed first world nations with democratic governance. There are hundreds of thousands of publicly traded companies worldwide, with the U.S. having around 19,000 of them. Being open to global investment has brought us major benefits and allowed for opportunities we otherwise would not have.

All of the above highlights what I believe matters and what will contribute most to our performance, so it is what I focus on. I believe the Pareto principle, also known as the 80/20 rule, is clearly at work in our operations. The fundamentals, which I can account for and which matter will bring us our returns. The other 80% of things that will not affect us much and which I cannot always account for, but which most people in the world of finance and business focus far too much of their time and energy on, should not be worried about. This includes what we all hear about on a daily basis in the news and financial media, including short-term forecasts, stock price predictions, macroeconomic predictions, what is trendy, new financial products and outlooks, etc. One of the principles of this firm is to essentially be the opposite of Wall Street and mainstream investment companies in that I focus nearly all of my time and energy on the important 20%- the fundamentals which drive our performance.

So after all of this (hopefully explanatory) discussion, when someone asks me about our operations, it is clear I cannot describe it in a few sentences without being extremely vague. Saying that we attempt to purchase cheap companies and take advantage of market fluctuations is of course accurate and would sum everything up, but I do not feel that adequately explains the methods of this company or our goals. Context, details, and proper analysis are what I believe separate us from others and none of that fits well with marketing slogans as it is not flashy- it is seen as boring as it takes time to understand and explain.

A low-cost market index fund such as an S&P 500 ETF is in nearly all cases the best investment option for the majority of investors. Most people would do quite well for themselves to purchase something similar and forget they own it for the next 30 years. The financial world is littered with high-cost funds which cannot outperform the index and various other high-commission financial assets for the sake of 'asset-allocation' and 'diversification' which generally all hinder long-term compounding and add little. There is a lot of unnecessary action in the world of finance and investment done with little reason and for negative results, for the benefit of those profiting from such useless action.

I believe that given our current size (being small allows for opportunities not afforded to others), expertise, and focus, this firm and its clients have an opportunity to continue generating above-average long-run returns. It is a matter of execution and a focus on the details of proper investment analysis and the factors which drive our performance, which are those I have outlined. It is of course my responsibility to provide this for us all, and this is where the value of this firm to its clients will come from.

As always, if you have any questions or concerns feel free to contact me and I would be happy to talk.

Best,

Aaron J. Saunders

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