

Comus Investment, LLC

Dear Partners,

October 1st, 2018

In the third quarter of 2018 we experienced a total return of -3.18% before fees and -3.81% after fees, versus 7.71% for the S&P 500. Year to date, we have generated a total return of 5.20% before fees and 4.57% after fees, versus 10.56% for the S&P 500.

Over the past 5 months, the market value of our portfolio has consistently declined (by about 6% in total), while the exact opposite has occurred for the S&P 500. Much of this has to do with recent volatility in Asian markets, as the price of nearly every one of the companies we own has declined. This of course, has happened without regard for what these companies are actually worth, and with little changing in their operating results. As a WSJ article published this morning noted, foreign markets have done quite poorly on average this year. In Asia specifically, half of the stock indices are negative for the year- China significantly so. In Japan, the year-to-date performance of the Nikkei 225 has just recently turned positive.

I have presented the above not because the figures are relevant to our long-term performance, but to help illuminate and provide context as to the high level of divergence and underperformance of our holdings in the third quarter.

Price declines are always beneficial for us- always. I repeated this nearly every quarter of the past 2.5 years because I initially expected much more volatility in our performance as well as more periods of underperformance/negative returns than we have experienced so far. This is our first negative quarter but I expect many more in the future. If you look at successful investors of the past, they all underperform in a significant percentage of years- I didn't expect us to be any different. Secondly and more importantly, I will repeat this as much as I can because we are going to experience large paper losses whenever a crash occurs. As I have explained before in letters and a blog post in detail, as long as the companies we own continue to produce satisfactory operating results, I would rather experience a -50% return in a single year than a 0% return, for the reasons below.

As investors, we all provide an outlay of cash to own companies. Our publicly traded companies both own and will generate a certain amount of cash in the future. As long as this amount remains constant, we will always be better off having to pay less for ownership. For example, if a company generates \$10 a year then to achieve a 10% annual return you would consider the fair value of the company to be around \$100. You would of course be better off paying \$50 for it though, and doubling your annual returns to 20%. Further, paying \$10 for the company is much better, as you would receive 100% annual returns. Market participants, traders, and the average consumer would (and do) look at such fluctuation with horror, but it would provide an enormously profitable opportunity for an investor. You would also want prices to remain low permanently, as you would have more time to reinvest and buy shares of companies delivering above-average returns. The ideal situation is that prices drop substantially and remain there permanently, or continue to drop forever. In each of those price drop scenarios, you would

experience a temporary paper loss, but as long as the company continues to make \$10 a year in profits, your returns have been increased dramatically moving forward. If on the other hand, the price of this company is \$200, your annual returns would be around 5%, and it gets worse as the price goes up.

The goal is long-term outperformance and good absolute returns, but particularly if markets are dropping, price drops are something that we should all see with optimism. Put simply, lower average prices lead to higher profits for us and if you like money it is what you should cheer for. This simple but counter-intuitive fact is one of the many reasons that long-term outperformance is both highly rare and difficult. We profit from that which most others will see as harmful or negative- we must both enjoy and take advantage of the chaos.

For us to achieve above-average returns, I generally have to purchase companies which have experienced a recent and significant drop in price. Another avenue that sometimes occurs is when a company has been increasing its net worth for years with positive earnings, but the price has remained flat.

So prior to my bread-and-butter purchase of a generally average company at an attractive price, it was once trading at an unattractive price at which owners would receive low returns- in most cases because it is a stagnant and boring company with stable earnings yet trading at around fair value. For the company to become a great investment, its price has to decline significantly, and with every percentage decline in price, future returns to owners increase. It then reaches the point at which despite being an average company it will deliver outstanding returns for owners- at which point I attempt to buy it. It is in most cases due to the fact that the majority of investors ignore or shun the stock that it eventually becomes a good investment as it is sold to the point of irrationality. Unfortunately, you cannot buy what is popular and expect to do well.

Something that is never said about “value investing” is that the concept of intrinsic value is something of a myth. The value of any business depends on the return you need from it, and is therefore relative. From the example above, if you only need a 5% return, you’d accept \$200 as the fair value of the company, but if you need a 10% return you’d see \$100 as the fair value. One’s view of intrinsic value, being the present value of all cash flows, is dependent on required returns.

For example, if most investors in the stock market need only a 5% annual return to be satisfied, then they would be willing to pay twice the price of investor A who wanted a 10% return. If the stock market as a whole was therefore valued by the majority of investors in this scenario, everyone would receive about a 5% return from holding the index, and investor A would view it as expensive/overvalued. Although it may be overvalued to investor A, his valuation of the market does not provide any forecasts as to changes in price, as the market could stay elevated indefinitely as everyone is satisfied with their single digit return. A business is only over or under-valued relative to the returns the investor needs; he cannot speak for all market participants.

This is the reason why I cannot say that the S&P 500 is overvalued (until its earnings yield is the same as that of average bond yields), but I can say with a high level of certainty that its future

returns will be historically low over the next decade- I believe 5% annual returns would be optimistic. Since 2010 the cumulative performance of the S&P 500 has been 190% while its earnings have increased only 60%- including the one-time increase from the 2017 tax cuts and the favorable showing in 2018. If you start at 2007 and include the recession, earnings have increased a total of 87% with cumulative returns of 180%. Investors in 2018 are apparently willing to pay much more for every dollar of earnings than they were in 2007. The average investor is paying higher prices for a group of companies that are on average growing at a very slow pace. As I laid out in last quarter's letter, this is a recipe for low returns.

The upward and incessant march of the S&P 500 to nose-bleed heights is of course not helpful for us or anyone else if they are considering the long-run. Traders and speculators will enjoy it, the average investor will feel richer on paper despite reinvesting for worse and worse returns, and it is particularly good for those selling financial products on commission and for fees, but as always, the paper gains are temporary.

The reason that the annual returns of the S&P 500 for the 20th century were 9.8% is that the math just doesn't work out to get double digit returns in the long-run. Basically, to hit 10% a year, the economy would have to grow at a long-term rate of over 5% per year, and valuations (the amount people are willing to pay for each dollar of earnings) would also have to be increasing. It didn't happen in the 20th century, and it almost certainly won't happen in the next 100 years. As the price of the S&P 500 continues to increase at a faster pace than its earnings, future average returns continue to drop. As cycles progress, people get more and more confident and expectations continue to increase- generally at the worst time. The economy and markets are cyclical and as a result they have a tendency to ruin expectations- the average sentiment is always best at the worst time, and worst at the best time. As a result, most people and institutions are buying when they should be selling, and vice versa.

John Keynes summed this up quite well with the following quote regarding his experience as the portfolio manager of an insurance company:

“When you find any one agreeing with you, change your mind. When I can persuade the Board of my Insurance Company to buy a share, that, I am learning from experience, is the right moment for selling it.”

As a result of our recent underperformance and the conditions of local markets in which we operate, we are near the top of my preferred number of stocks held at 19. This may increase depending on changes in price and my willingness to shuffle things around slightly. If foreign markets continue their divergence from U.S. markets, it will continue to benefit our returns relative to the S&P 500 going forward.

Best,

Aaron J. Saunders

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