Comus Investment, LLC

Dear Partners,

September 30th, 2019

In the third quarter of 2019 our investments experienced a total return of -2.30% before fees and -2.93% after fees, versus 1.70% for the S&P 500 index. Year to date, we have generated a total return of 2.97% before fees and 1.71% after fees, versus 20.55% for the S&P 500 index.

Our performance so far this year has been poor, and I have personally enjoyed the price stagnation we have experienced. This stagnation has come with sharp declines in a few stocks we have recently picked up, along with most of the rest slowly declining- our nominal profits have come from a few stocks which have appreciated somewhat. This deviation of outcomes in our stocks is better than if each stock appreciated at the same low rate- it allows us to buy more of the decliners at better prices if we have the capacity.

Each month I invest all my pay less basic expenses into our portfolio, and I almost never have much cash. As a result, I can't regularly reinvest more than I already am, but the sharp declines in a few of our stocks have brought a noticeable increase in the number of shares I am able to purchase with my monthly deposits. I would honestly be annoyed if any of these targeted stocks which we all own and which I continue to buy rapidly appreciated, despite the improvement it would have on our performance.

I've written in the past that you can make money in the short-term if all stocks rapidly appreciated, but you could make much more if they all rapidly declined and remained at their newfound price. We are currently in the latter environment and I'd prefer that we stayed there. For investors who care about their total profits (money-weighted returns), this is a desirable place to be as you can put more money in at favorable prices. I am happy to be focused on an environment which allows investors to purchase income-producing assets at ever lower prices.

A few investors have asked for me to explain our YTD performance and whether macroeconomic or political factors affect my assessment of stocks, often noting recent geo-political developments. The short answers with respect to each question are that it is difficult to say, and no.

Investors and traders wake up daily and check market movements to see how their investments and the global indices have performed. The market however, is just every other investor and prices are governed by the transactions made over the time period in which you are assessing performance. This simply means that daily performance is determined by the group of all other investors who have bought or sold stocks on that day. Looking at your performance over a certain time period is therefore the same as asking other investors what they think of the companies you own and how their opinion has changed over that period, then taking this information as meaningful. If I were to take our performance since January as meaningful, I would be saying that every other investor who has bought or sold the stocks we own in this period of time knows more about our companies than I do.

Unfortunately, as small/passive investors we eventually rely on the collective judgement of the market over a period of 3-5 years to profit, but if I were a controlling investor it would never matter and returns would come only from the stream of cash flows our companies generate which could be used to buy back stock or pay dividends. Given that I only care about intrinsic value, my opinions don't change based on stock price movements. I understand that our relative underperformance vs. the U.S. so far this year would make most investors nervous, but it doesn't affect my decision making at all.

Most investors do care to some degree about their recent performance, meaning they take momentum into account and care about the opinions of others. Factors such as momentum, macroeconomics, trade, politics, etc. often have little to no impact on intrinsic value for our companies but create a lot of noise and price movement. The fact that they create miniscule or no changes in value but large swings in price means that they often serve to provide us with an opportunity to profit as most other investors believe they carry some weight. What matters to our results then, isn't an assessment of how every extrinsic variable will impact the profitability of our companies, but the fact that other investors will trade based on factors unrelated to intrinsic value.

If you place the momentum factor under the microscope briefly, you will realize how irrational it is. Again, most investors care about momentum, meaning that investors prefer to purchase stocks which have been rising and would rather sell stocks which have been declining. This creates reflexivity in markets, meaning what goes up continues to go up and vice-versa, at least in the short-run. These investors would all prefer to be the highest bidder at an auction for a popular item (because the bid has rapidly increased) rather than be the only bidder at an obscure auction. I don't know about you, but I wouldn't want to pay more for an item merely because others want to pay more for it.

We can take a look at the market for U.S. treasuries to see how winners of this auction will fare. The 30-year U.S. Treasury bond issued in early 2019 is up about 25% YTD, despite the fact that it yields less than 3% a year if purchased at par. To understand how a security with a guaranteed annual return of less than 3% can appreciate 25% in 9 months, you only have to look at the yield curve over this period. Since January, the 30-yr rate has dropped from about 3% to 2.15% as of Sept 26, meaning that investors will pay above par for the 3% bond. As a result, our portfolio has dramatically underperformed a security with a near-zero long-term return. If interest rates continue to decline, as I believe they will, the 30-yr yielding 3% could continue to appreciate to the point at which new investors would eventually receive negative returns over the life of the security, but its short-term performance would be remarkably good. To explain to you why we have underperformed long-duration treasuries would be a strange discussion and I would have to speculate on the reasons why certain institutions are willing to receive lower yields for the next 30 years.

By definition, value investing is unpopular- it always has been and it always will be. Even within the small group of investors focused on intrinsic value, most believe that no price is low enough to buy an average business. Instead of evaluating each stock on its merits, most tend to only seek out those which they would like to own. If you were to poll every investor, most would not want to invest in the countries, sectors or companies that we are in- as a result there will always be popular reasons to avoid certain stocks regardless of price, it's just that those reasons often aren't very good.

The rest of this letter will provide my thoughts on an assortment of market-related topics that I find unusual and which may be of interest to some readers- if you find security analysis tedious feel free to skip it.

Firstly, the term dividend-investor makes no sense at all to me, and it makes even less sense than the fabricated demarcation between supposed growth and value investors. Dividend-investing often implies that one is investing with the goal to receive a current yield at the expense of long-term capital appreciation as if the two sources of returns are distinct (they aren't).

Regardless of whether it is paid out or reinvested to increase earnings, intrinsic value to the investor comes from the potential cash flows to equity that *could be* paid out. Whether the investor would like it retained or paid out depends on their required returns versus the incremental returns on capital of the business owned, with investors clamoring for a payout whenever the firm's organic returns on new capital invested trail behind the investor's cost of capital.

If stocks were priced fairly, regardless of whether the firm paid out or retained the earnings, investors would receive similar returns. Dividend investors are saying that they are unable to properly value securities or determine long-term cash flows to equity, but invest primarily on the basis of current payout and apparent stability/safety. The problem is that to determine both current and long-term payouts, the investor must be able to estimate the cash flows the company will generate over its life, and dividend investors are either unwilling or unable to do so. As a result, they will also have no ability to compare the stock's current price to its current or future payouts, meaning they cannot assess or estimate their expected long-term returns. They are trying to have their cake and eat it too- if they cannot value securities they shouldn't be investing and if they are actively investing they should be able to value securities, which they refuse to do.

Some of these popular dividend stocks are as risky as they come. I have mentioned Coca Cola in the past and I'll use it again quickly as an example. I would much rather receive Coca Cola's current stock price of $54/share and pay out all future cash flows to equity per share over the life of the business rather than pay $54/share and receive those cash flows- meaning I would much rather short the stock than own it given the marginal returns it will deliver (it would be similar to taking on debt at a cost of around 3% a year). In the short-term, the stock price could appreciate to nearly any point given the market's propensity to overestimate future cash flows and value those future cash flows at near-zero rates. The fact that short positions are constantly marked to the current price excludes most wise investors from ever shorting, but based on intrinsic value alone, I think it is a very obvious short candidate. I would say the exact same thing for its bedfellow, McDonalds. There are at least 50 similar stocks that dividend investors would deem safe and worthy of a position at current payout yields, but which a decent investor with a reasonable cost of capital would love to short if positions were marked on a much longer-term basis.

Any tech investors reading this will likely roll their eyes given how often they are mentioned but I have to bring up the SAAS basket of stocks. I believe it is lower now, but last I saw the entire group of public SAAS-related stocks was valued above 10x sales. This is similar to 100 fishermen at a single lake estimating they can each catch a fish a day with only 10 fish in the lake- for the fishermen to be right the fish will have to reproduce extremely quickly. The entire industry is valued as if every investor will do extraordinarily well and each business is valued as if it will experience organic ROE's of 20%+ for decades.

Most SAAS segments are highly fragmented and I rarely see significant barriers to entry or an ability to differentiate vis-à-vis competitors. It is often the case that fragmented markets are more competitive, so how all incumbents are expected to be highly profitable is beyond me.

To maintain belief in current valuations and large losses in the face of expanding revenues, tech investors cling to the fact that SAAS firms expense costs in the present which will provide benefits for years to come, while they receive subscription revenues instead of upfront payment, meaning that revenues and the costs of those revenues are mismatched. This is often the case, and some firms may experience substantial profitability when growth slows, but high profitability in maturity is the exception and not the rule.

The best SAAS stocks have the same mismatch issue but are profitable regardless, a good example being Paycom which was profitable years before its IPO and on a small base of revenues. Clearly having lower costs, lower competition and higher prices all improve results.

New accounting changes are also attempting to mitigate the mismatch. One such change was ASU 2014-09 which allows companies to capitalize certain costs related to obtaining new contracts and customers, such as commissions, marketing expenses, and upfront service and labor costs, which are then amortized over the expected life of the contract. Most SAAS firms made this change in 2019 and it hasn't improved the results of the loss-makers much. While it helps alleviate the accounting mismatch, the contract lives are estimated based on current churn-rates which can be subject to dramatic change in the future- more than a few firms note the risk of capitalized cost impairment if their assumptions regarding customer lifetimes are off a bit. In such a highly volatile industry there will be the incentive to play accounting games and no doubt some companies will realize impairment on these costs in the future.

In a highly fragmented and rapidly changing industry, many of these companies will require ongoing investments in software improvements that cannot be amortized over 10+ years if they would like to maintain customer renewals. I suspect that depreciation of their product will often happen at rates faster than most expect and many of these costs will be deemed to be ongoing and very real expenses, primarily in employee development and support costs.

Many high-growth SAAS firms have unique features in their accounting which make current and/or future results very hazy. With large losses, the substantial employee compensation costs and resulting dilution from the exercise of options and issuance of shares actually reduces losses per share. It is likely that at current valuations, owners benefit from substantial stock issuance as the future losses are spread over more stockholders and as the firm receives cash per share substantially in excess of the intrinsic value per share- this comes at the direct expense of new stockholders.

This also does a few strange things to the cash flow statement. Most investors claim that cash flows cannot be manipulated, but I couldn't disagree more. Firstly, most SAAS firms have the largest percentage of costs in employees- often in options compensation. This is always added back to earnings to come to the cash flow from operations (CFO) figure. This very real cost to owners which is added back makes CFO look better than it really is and can range from 50-100% of the CFO number. Many SAAS firms would have negative CFO including these compensation costs along with the associated tax benefits. This makes both CFO and free cash flow look permanently higher than they truly are. It also provides a secondary cash benefit, because when employee stock options are exercised the firm receives the exercise price in cash, often hidden in the financing section. All in all, the result is that losses per share improves, CFO improves, FCF improves, and the firm has more cash than it otherwise would.

The long-term earning power and cash generating ability can therefore be hidden for long periods of time and difficult to measure. Much of these concerns are resolved in the minds of tech investors with a popular focus on a SAAS firm's LTV and CAC numbers. Tren Griffin of Microsoft summarized it on his popular 25iq blog by saying that trying to value a subscription business "with a P/E ratio is like trying to open a can of corn with a pickle". Fair enough, but I would say that trying to value it with an LTV/CAC assessment is like trying to open the can with a raw cucumber since the pickle didn't work out.

Both LTV and CAC are estimates based on historical numbers that may or may not be relevant, as well as future numbers which may be impossible to measure. LTV generally takes the contribution margin on costs deemed fixed and compares it to direct customer acquisition costs that are expensed in the present. The problem is most of these fixed costs aren't fixed at all, and it is impossible to know what the per-customer margin on those costs is if you don't know how many customers the firm will have in maturity. To measure LTV you are therefore making assumptions regarding future fixed costs, revenues per user, and the number of total users. It is simply a roundabout and indirect discounted-cash flow model and is no more useful than estimating the number of users a firm will have 10-20 years from now and considering its total costs versus revenues and invested capital. With the rapid change and obsolescence of software, it would be silly to think that current churn rates and demand for products will hold up 10 years from now, so often LTV/CAC numbers are built on whimsical assumptions about conditions years down the road.

If you held the SAAS basket you would be doing very well this year, probably 30%+ and I suspect returns for this group will be extraordinary (as they have been since 2013) until they suddenly aren't. Some of them will do very well, but I believe most will experience marginal profitability and significant competition down the road. Buying a group of popular SAAS stocks at 20x revenues with the expectation that your winners will make up for your losers is the equivalent of public-company venture capital investing and has become very popular. I believe in most cases investors will experience permanent losses as the undiscounted future cash flows per share will rarely match the current price per share, say nothing of requiring a decent return.

Best,

Aaron J. Saunders

Owner & Manager, Comus Investment, LLC.

asaunders@comusinvestment.com