5250 N. Lankershim Blvd. Suite 500 | North Hollywood, CA 92601
818-210-5060 | mlee@hypotenusecap.com

2017 Annual Letter to Investors

PRIVATE AND CONFIDENTIAL

Our purpose is to **enable aspirations**.

There are many kinds of aspirations we can help fund: retirement, world travel, a philanthropic cause, developing life-changing innovations for humanity, or providing education for a future generation of dreamers.

To achieve these aspirations we seek organizations and individuals building great businesses.

Our mission is to find **outstanding companies** led by **exceptional individuals** and **invest intelligently** in them.

If we execute this mission well over the long-term, there is no limit to the aspirations we can achieve.

Dear Partners and Friends,

	Partnership Gross[1]	Partnership Net[2]	S&P 500 Index (TR)
2013[3]	14.5%	11.1%	23.5%
2014	(1.2)	(2.6)	13.0
2015	(15.8)	(17.1)	0.8
2016	24.2	22.4	11.2
2017[4]	**21.6**	**16.7**	**21.1**
Inception-to-Date CAGR[3]	7.9	5.3	14.1

2017 was another strong year for the partnership. Our 21.6% gross return was driven primarily by a small group of investments in our concentrated portfolio. The top five winners in our portfolio contributed approximately 19% to the gross return while the worst five losers lost about 4%. Four different positions contributed 300 basis points or more to the gross return and no single position lost more than 100 basis points.

Over the past two years, the Partnership has returned 43% net, which compares favorably to the prior two years ended December 2015 when the Fund lost (19%); our results are also favorable compared to the S&P 500 Total Return Index which returned 35% over the past two years. The improvement in the Fund's performance is due, in part, to holding on and adding to positions that declined in value during 2015. Additionally, part of the improved performance derives from the changes we implemented in our investment strategy and processes after 2015. Upon adopting these changes, we pruned mediocre businesses with unremarkable managers out of the portfolio and focused our attention and capital on outstanding companies with exceptional leaders. Two years is a relatively short interval over which to measure an investment portfolio's performance, yet I am encouraged that these results suggest that these changes are providing traction to the Fund.

While we have made considerable progress over the past two years, due to the losses incurred in 2014 and 2015, our performance since inception still trails the index by a considerable margin. I will continue to work diligently towards delivering prosperous returns for the Partnership, but it is important for you to know that I will not take excessive risk by putting our capital in unduly precarious situations. Consequently, I avoid portfolio margin debt, heavily indebted companies, and other such speculative investment options. In case you are wondering, no, you should not expect to see any cryptocurrencies in our portfolio in the foreseeable future. There will be no "Hail Mary" plays attempting to even the score with the index, only fundamental blocking and tackling based on our simple strategy:

1. Find <u>outstanding companies</u> run by <u>exceptional leaders</u>
2. <u>Invest intelligently</u> in their securities at good prices
3. Maintain a sizable reserve of cash so that we can <u>capitalize on future opportunities</u>

Note: your returns may vary from those discussed herein based upon a variety of factors including the date on which you subscribed to the Fund.

[1] Represents Partnership returns before management fees and incentive allocations but after expenses.

[2] Represents Partnership returns after all fees, allocations and expenses.

[3] The Fund began operations on March 1, 2013.

[4] Unaudited.

Portfolio Positioning

	12/31/17	6/30/17	Change
Long equities	84%	81%	3
Corporate bonds and preferred	5	6	(1)
Long options	–	1	(1)
Short options	(1)	(1)	–
Short hedge (fixed-income related)	(5)	(8)	3
Cash and other	17	21	(4)

The net percentage of our capital invested has increased since our midyear letter primarily due to positive performance of our long portfolio, reduction of our short fixed-income related hedge, and the addition of a small new position. This was partially offset by reducing the size of certain positions that had appreciated considerably in value during the year. Consequently, cash declined a bit during the second half. As discussed above, our strategy is to maintain a sizeable reserve of cash so that we may capitalize on future opportunities that may arise.

Top Five Positions

Position	% of NAV	Comments	Valuation
Total Energy Services	27% equity	• Exceptional leadership team with an outstanding track record of value-creative capital allocation • Recently completed takeover of Savanna Energy	~5x normalized EPS and ~1x Tangible Book Value.
Itasca Capital Ltd.	13% equity	• Investment holding company controlled by disciplined capital allocators	~30% discount to NAV
Tucows Inc.	12% equity	• #2 player in internet domain registration services • Investing in growing internet access businesses • Exceptional leader and high-quality corporate culture	~7x projected earnings.
Industrial Company "Supernova"	11% equity	• Niche manufacturer of critical industrial machinery parts • Wide moat around product design and manufacturing • Exceptional management team and organizational culture	~8% cash flow yield (at cost).
Pendrell Corp.	8% equity	• Significant undeployed cash balance • Sizeable deferred tax assets • Savvy capital allocator CEO	Trading at a discount to cash. Free option value for tax assets.
Total Top 5	**71%**		

I remain optimistic about Total Energy's prospects given the strengthening of the North American energy markets. Oil and gas prices have recovered significantly from their trough levels in 2016 while commercial inventories have declined. Meanwhile, recent cold weather in North America should continue to provide a tailwind to demand. As energy prices have climbed, we are seeing producers increase drilling activity to bring on additional supply. Such increase in drilling activity will likely benefit Total's various energy services businesses in the quarters to come.

Limbach Holdings recently announced that it had repurchased all outstanding shares of its preferred stock which previously constituted the bulk of the net asset value of Itasca's investment in 1347 Investors LLC. This liquidity event may provide a positive catalyst to our investment in Itasca.

Tucows Inc., which I previously described as "Tortoise" saw its share price rally strongly in the second half of 2017. The company reported solid quarterly earnings as it integrated the acquisition of a competing internet domains registration platform from earlier in 2017. This January a firm called Copperfield Research published a short thesis on Tucows causing the stock to sell off by about 20% so far in 2018. Some of the issues raised by Copperfield do bring up decisions made by the company that merit deeper discussion. Other arguments made by Copperfield were less convincing. After discussing these matters with Tucows, I believe that our investment thesis in Tucows remains intact; however, it will take some time before the company sufficiently proves itself in the eyes of investors to clear away the Copperfield overhang.

"Supernova" continues to report strong operating results. Rising business sentiment indicators such as the ISM Purchasing Managers Index suggest that expansion in industrial activity will continue for the foreseeable future. Meanwhile, the devastation wrought by last year's hurricanes, earthquakes and wildfires means that there is a considerable amount of reconstruction work that will need to be done in the U.S. and abroad. Machines built using Supernova's mission-critical components will play an integral role in the rebuilding of homes, roads and other projects in affected areas.

As expected, Pendrell Corp. delisted from the NADAQ exchange during the fourth quarter. The company believes that this delisting will save the company unnecessary public company compliance expenses and provide it with better access to potential opportunities to acquire privately held businesses. The stock continues to trade in the over-the-counter Pink Sheets at a material discount to the value of the cash and current assets on the balance sheet.

On Preparation

"By failing to prepare, you are preparing to fail." –Benjamin Franklin

The past two years have been a rather benign and pleasant environment from the perspective of the typical equity investor. Falling unemployment levels, low interest rates, historically low equity volatility and general expansion in the global economy have created fertile conditions for rising equity valuations. Yet, trees will not grow to the sky; at some point the gravity of the business cycle will take hold, and the economic cycle will revert from expansion to contraction.

To be perfectly clear, I am not "calling the top" on the current cycle. I have no idea if the market will go up or down tomorrow or at any given point in the future. In fact, the current economic data seem to

suggest that further growth of the economy is likely this year, and consequently there may still be some upside to equity valuations yet.

Nonetheless, wise investors know to take Benjamin Franklin's advice to heart. We as Partners must be prepared for the day when stock prices stop going up and inevitably begin to fall. At the portfolio level, I have put in place a small amount of insurance in the form of option contracts that will cushion some of the blow from a severe correction in U.S. equity prices. In addition, as discussed above, I always keep a significant amount of "dry powder" available in the form of cash to take advantage of opportunities that may arise from a more volatile equity environment. Preparing the portfolio in this manner allows me to act with confidence when the predominant market sentiment shifts from greed to fear. In last year's annual letter I wrote, "Although it requires some patience and fortitude, it is our occasional and opportunistic willingness to march into the breach when others are panicking to rush out that will ultimately distinguish our investment results over the long-run." Similarly, in the 2015 annual letter I argued, "…volatility is not something to ***fear***, it is something to ***embrace***. The best bargains are to be had when everyone is selling, not when everyone is buying. For value investors such as us, ***volatility is a source of opportunity***."

The Partners of this Fund are an extraordinary lot. Among its members are doctors, lawyers, entrepreneurs, corporate executives and even other professional investment managers. I am honored to count so many intelligent and upstanding individuals in this group. At the end of 2015 when the Fund had suffered two straight years of losses, no Partner redeemed from the Fund on account of our performance. In fact, one intrepid soul opened a ***new*** account with the Fund at that time, effectively buying at the nadir of our Partnership's drawdown. This Partner has been rewarded exceedingly well in the subsequent two years. I want to thank you all for your patience and trust; it certainly makes it easier for me to focus on my job of deploying our capital intelligently.

I encourage every Partner in the Fund to prepare for the day when volatility again returns to the marketplace and be ready to deploy additional capital into the Partnership. Swimming against the crowd is not easy and requires clear-headed perspective and tenacity; these are traits which I know that our Partners have in spades.

"Opportunity comes to the prepared mind." –Charlie Munger

Firm Updates

In the second half of 2017 we continued the first's trend of admitting new Partners to the Fund. We also have raised some incremental funds through additional subscriptions from existing Partners. As I mentioned in my previous letter, although we are currently open to admitting new Partners, such will not be the case indefinitely. Our capacity to do so will ultimately be limited by operational and regulatory constraints. If you or someone you know would be interested in securing one of the remaining spots in the Fund, please reach out to me directly for subscription information. As a reminder, all Partners must be accredited U.S. investors.

Previous letters as well as various interviews, investment theses and presentations continue to be available on the Fund's website at www.hypotenusecap.com/download.

I remain committed to enabling our aspirations while protecting and growing our capital over the years to come. Should you have any questions concerning the Partnership's activities or your account, please do not hesitate to reach out to me.

Warmly,

Michael J. Lee

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