HYPOTENUSE
CAPITAL MANAGEMENT, LLC

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

2018 Annual Letter to Investors

PRIVATE AND CONFIDENTIAL

Our <u>purpose</u> 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.

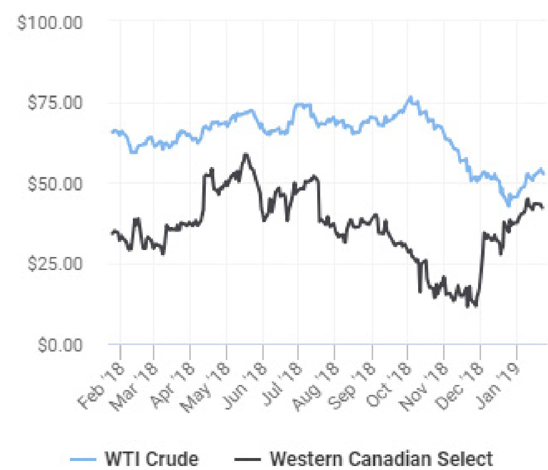
Our <u>mission</u> is to find **outstanding companies** led by **exceptional individuals** and **invest intelligently** in them.

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

	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	21.6	16.7	21.1
2018[4]	**(22.6)**	**(23.8)**	**(4.9)**
Three-Year CAGR	5.3	2.9	8.6
Inception-to-Date CAGR[3]	1.9	(0.4)	10.6

Dear Partners and Friends,

2018 was a tumultuous year for the Partnership as NAV declined by 24% on a net basis. The fourth quarter was a roller coaster as the Fund's NAV declined 12% in the last three months of the year. While this all might feel nauseating at first blush, I know each Partner in the Fund understands that volatility is a *source of opportunity* that is something to be *embraced rather than feared*.



Although the publicly quoted prices of our investments may have declined significantly, I do not see permanent value impairments in our holdings. To the contrary, in most cases we are observing improving underlying fundamentals that strengthen our case for investment in these businesses. Take, for example, the Canadian energy services company ("Titan") which is our largest holding and whose share price declined by 34% over the course of 2018. Many publicly traded Canadian energy firms had a challenging year due to lack of adequate pipeline transport capacity to move oil and gas from Canada's main resource producing region in Alberta to end markets, such as the Canadian and US eastern seaboard or refining hubs near the Gulf of Mexico. This lack of transport capacity has meant that Canadian oil typically trades at a substantial discount to the US West Texas Intermediate ("WTI") benchmark. This discount widened considerably during the fourth quarter of 2018 as projects to build additional pipeline capacity faced political opposition and financial markets swooned. At its low point, the Western Canadian Select index was trading near $12 per barrel compared to $50 per barrel for WTI.

We have been involved in Titan for a number of years and bought a sizable stake in the company during the oil market recession from 2014 to 2016 when WTI declined from over $90 to $35 per barrel. Our

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.

thesis has been predicated on the belief that Titan is managed by a skilled and disciplined management team that has:

- Maintained a tight ship and generated a consistent track record of positive cash flow, even during volatile downturns in oil prices
- Used these downturns as opportunities to acquire weaker competitors at a discount to intrinsic value
- Produced excellent shareholder returns over a multi-decade time horizon

In spite of the challenges associated with operating in Canada, Titan has delivered strategic and operational results in line with, if not better than, our expectations. The company has maintained positive cash flow throughout the prolonged oil bear market that began in 2014 and completed a transformative acquisition that doubled the size of its balance sheet in 2017 while only paying a fraction of book value for the target. Meanwhile, the company has increased its focus on the U.S. by both moving existing assets to the States as well as building new manufacturing facilities south of the border. Consequently, Titan is currently generating record operating profits that are even higher than the previous market peak in 2014 and also enjoys a much more geographically diverse book of business, with over half of its revenues now coming from territories outside of Canada.

In sum, Titan has bucked the Canadian trend by managing its operations prudently, deploying its capital wisely, diversifying its geographical footprint and delivering record cash flow. Yet in spite of Titan's strong fundamental performance, the stock still declined during the year. This is a sobering reminder that sometimes stocks don't always trade in line with the underlying fundamentals. The late John Bogle said, "The stock market turns out to be a giant distraction from the reality of owning businesses, which is what investing really is." We have focused on finding and investing in great businesses; nonetheless the stock market can behave in unpredictable ways in the short-term. Still, we will continue to stick to our simple investment 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>

Our portfolio is very concentrated and consequently our results have been and will continue to be volatile, particularly over short measurement periods. However, if we stick to our philosophy of investing wisely in excellent companies, I expect our results to be satisfactory over the long term.

Portfolio Positioning

	Current	June 2018	Change
Long equities	71%	82%	(11)
Corporate bonds and preferred	6	6	–
Long options	1	1	–
Short options	(1)	(1)	–
Cash and other	23	12	11

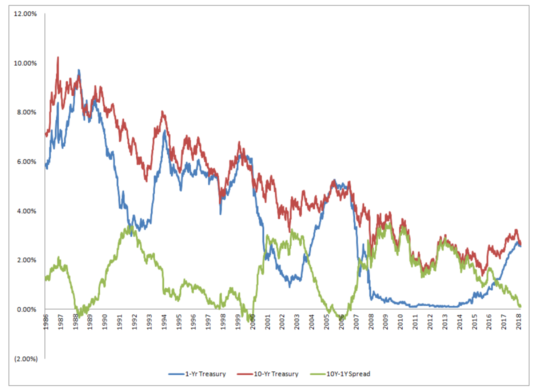
Net cash has increased since the midyear review due to a combination of the following:

- Exiting our investment in Industrial Company "Supernova" – this continues to be an excellently run company, however given that its business is highly correlated with industrial capital expenditures and that it had reached a price that was relatively stretched compared to its value, it was prudent to exit our investment at a significant gain over our cost basis.
- Exiting our investment in Special Situation "Kilo" – although I had high hopes for this investment when we first purchased it at a considerable discount to the value of the cash and securities on its balance sheet, I have changed my perspective on its management team as time has passed and new information has come to light. We have exited our investment having recovered proceeds approximating 93% of our initial investment.
- Option writing proceeds – the high levels of market volatility during the past few months provided opportunities to write put options against a number of businesses trading at attractive valuations. Although we wrote a fairly sizable number of these options, most have expired out of the money without having the underlying shares assigned to us. Consequently, the option premiums we received have converted into cash now available to us to invest in other opportunities going forward.
- Relative outperformance of our cash, bond and other investments relative to the rest of the portfolio.
- The activities above were partially offset by purchases of new investments which I discuss below.

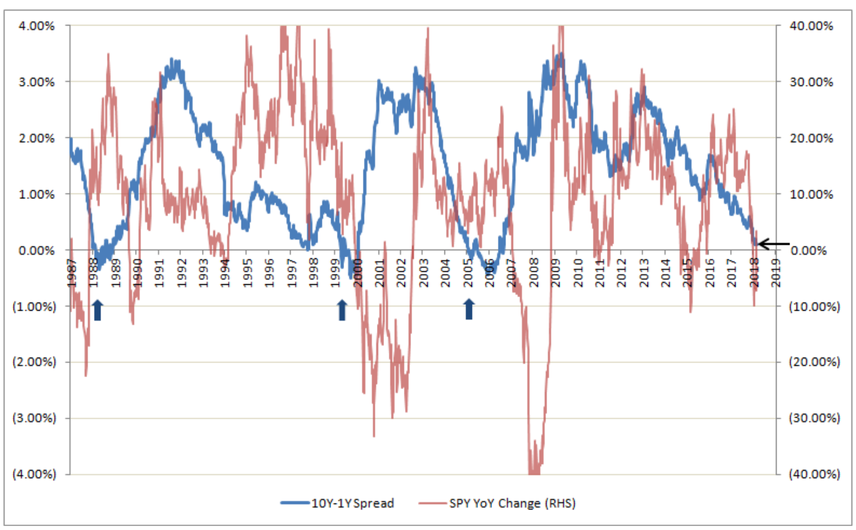
Of Hawks and Doves

In late 2018 and into January this year, markets were extraordinarily jittery as headline news seemed to be bad just about everywhere one looked, from bellwether companies reporting disappointing operating results, to trade disputes and government shutdowns. I was particularly concerned about developments in the Federal Reserve Bank's monetary policies. I saw two main threats to the health of the financial system: 1) rising short-term interest rates and 2) negative liquidity effects of so-called "Quantitative Tightening."

On the first point, the Fed had been gradually raising short-term interest rates since late 2015 after a long duration of "zero interest rate policy" or "ZIRP" since the Great Financial Crisis of 2008. With the economy showing reasonable rates of growth and declining toward pre-crisis levels, this appeared to be a reasonable course of action. However, late in 2018, the interest rate curve (as measured by the difference between the yield on 10-year and 1-year Treasuries) flattened considerably and was on the cusp of inverting by the end of the year.



Yield curve inversions have been reliable predictors of economic recessions and equity bear markets as illustrated in the chart below.



Given the Fed's trajectory of interest rate hikes throughout 2018, an inversion of the yield curve and subsequent recession seemed a foregone conclusion until recently.

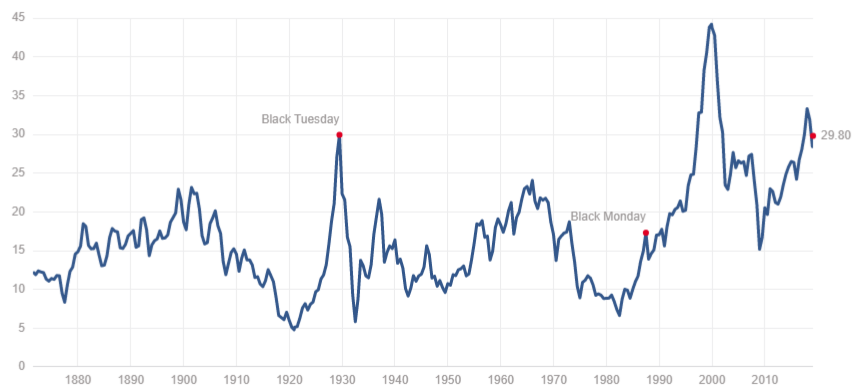
Secondly, the Fed's Quantitative Tightening, which began in late 2017, reached a pace of $50 billion per month during the fourth quarter. Whereas former Fed Chairman Ben Bernanke likened Quantitative Easing to dropping money into the market from helicopters, Quantitative Tightening ("QT") has the opposite effect and *removes cash* from the markets. To put this in perspective, QT of $50 billion per month is like burning a pile of cash equivalent to a General Dynamics or Raytheon (both of which have market capitalizations of roughly $50 billion) with a simple journal entry on the Federal Reserve's ledger. QT is a Fed-induced evaporation of liquidity from financial markets puts downward pressure on security prices.

"When the facts change, I change my mind. What do you do, sir?" — John Maynard Keynes

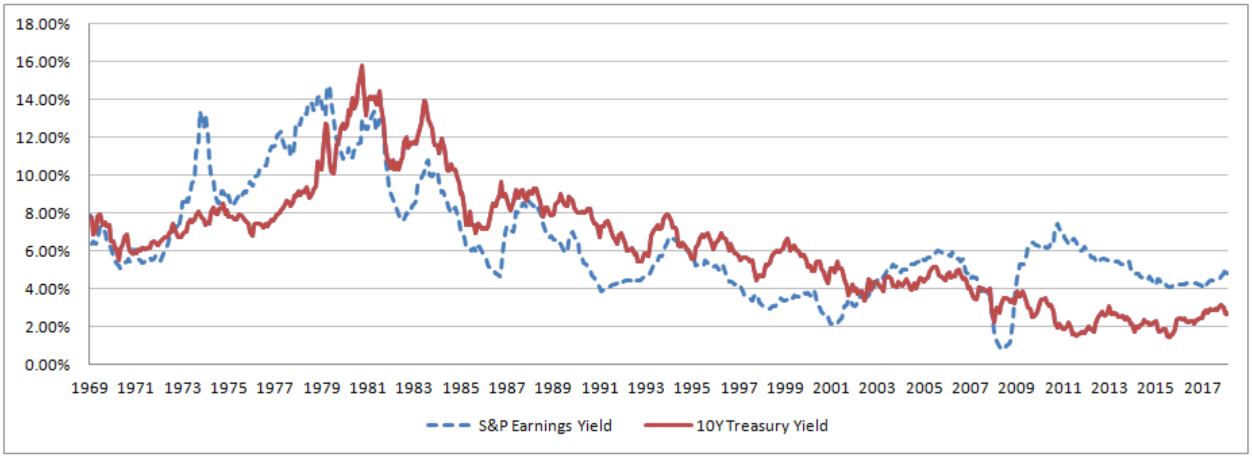
Things changed significantly in late January when the Fed shifted its tone regarding further interest rate increases. Whereas the Fed had previously signaled that more rate increases were likely warranted in 2019, the Fed has now stated that it "will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." Moreover, the Fed also signaled that it may be prepared to adjust its timeline for QT, making an earlier end to the tightening process a possibility.

Does the Fed's shift to a more dovish policy imply that interest rate hikes are on hold indefinitely? If so, is it possible that the Fed is acting to prevent the yield curve from inverting, thereby avoiding a possible economic recession and equity bear market? Such questions are inherently difficult to answer. I am extraordinarily wary of the potential folly in declaring "this time is different." Nonetheless, the facts have changed since just a few weeks ago and it seems prudent to ponder those changes carefully. Whereas in December my instincts were to maintain a highly defensive portfolio position pending an imminent inversion of the interest rate curve, it now seems possible that such an inversion may be indefinitely delayed and a more constructive portfolio stance likewise may be warranted.

<u>Schiller Cyclically Adjusted PE Ratio</u>



Some market observers might note that equities still appear expensive even in light of the recent market correction. The Schiller Cyclically Adjusted PE (or "CAPE") ratio would suggest that the market is dear compared to historical precedent. However, the CAPE ratio alone tells only part of the story. Equity earnings yields in the context of interest rates tell a slightly different tale, as illustrated below.



Although it is true that equity earnings yields are low compared to historical levels, particularly those that prevailed in the 1980s, interest rates have fallen dramatically since then as well. Today, the S&P Index continues to trade at an earnings yield that has a considerable positive spread relative to 10-year Treasuries whereas that spread was negative throughout the 1980s and 1990s. I cannot say whether or not the current spread between the two curves is appropriate; however, *if interest rate hikes are on hold*, then one can argue that current equity valuations are justifiable given current bond yields.

In the meantime, I continue to focus my time on identifying outstanding companies run by exceptional leaders. The recent market turbulence has offered us new opportunities to deploy capital in some truly wonderful businesses. In the past few months we have put capital to work in a globally dominant media enterprise, a similarly dominant technology platform company, and a rapidly growing software services firm. Meanwhile we continue to evaluate a number of intriguing prospects both in the U.S. and abroad, ranging from an industrial distributor in the United Kingdom to a consumer services firm in the Asia Pacific region. Our actionable opportunity set of outstanding companies run by exceptional leaders has grown meaningfully in the recent months and I am optimistic about finding intelligent ways to invest our funds.

Firm Updates

I am pleased to report that the Partners in this Fund continue to show remarkable resilience and resolve; no Partners have retired from the Partnership as a result of the current drawdown and some of you have inquired about investing additional capital with us. Having patient and opportunistic Partners such as ours is a vital component to the long-term success of the Fund.

We continue to accept additional capital subscriptions from existing Partners as well as select prospective Partners who are suitably aligned with our investment horizon and philosophy. Again, our capacity to accept additional capital 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

DISCLAIMER STATEMENT

THE INFORMATION PRESENTED HEREIN REPRESENTS THE VIEWS OF HYPOTENUSE CAPITAL MANAGEMENT, LLC ("HCM") AND IS NOT TO BE CONSIDERED INVESTMENT ADVICE. NOTHING HEREIN SHOULD BE CONSIDERED A RECOMMENDATION TO PURCHASE OR SELL ANY PARTICULAR SECURITY OR OTHER FINANCIAL INSTRUMENT. THERE CAN BE NO ASSURANCE THAT ANY SECURITIES DISCUSSED HEREIN WILL REMAIN IN HYPOTENUSE CAPITAL PARTNERS, LP'S (THE "FUND") PORTFOLIO OR, IF SOLD, WILL NOT BE REPURCHASED. FURTHERMORE, HCM MAY SEEK TO ADD TO THE FUND'S POSITIONS IN THE SECURITIES DISCUSSED HEREIN, OR HEDGE AGAINST SUCH POSITIONS. THE SECURITIES DISCUSSED IN THIS DOCUMENT DO NOT REPRESENT THE FUND'S ENTIRE PORTFOLIO AND MAY REPRESENT ONLY A SMALL PERCENTAGE OF THE FUND'S PORTFOLIO HOLDINGS. IT SHOULD NOT BE ASSUMED THAT THE HOLDINGS DISCUSSED IN THIS DOCUMENT HAVE BEEN OR WILL BE PROFITABLE, OR THAT RECOMMENDATIONS MADE IN THE FUTURE WILL BE PROFITABLE OR WILL EQUAL THE INVESTMENT PERFORMANCE OF THE SECURITIES DISCUSSED HEREIN. MOREOVER, THE RISK LIMITS AND HEDGES ON THE POSITION ARE NOT DISCLOSED.

THIS DOCUMENT, WHICH IS BEING PROVIDED ON A CONFIDENTIAL BASIS, SHALL NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF ANY OFFER TO BUY WHICH MAY ONLY BE MADE AT THE TIME A QUALIFIED OFFEREE RECEIVES A CONFIDENTIAL PRIVATE OFFERING MEMORANDUM (THE "MEMORANDUM") OF THE FUND, WHICH CONTAINS IMPORTANT INFORMATION (INCLUDING INVESTMENT OBJECTIVE, POLICIES, RISK FACTORS, FEES, TAX IMPLICATIONS AND RELEVANT QUALIFICATIONS), AND ONLY IN THOSE JURISDICTIONS WHERE PERMITTED BY LAW. IN THE CASE OF ANY INCONSISTENCY BETWEEN THE DESCRIPTIONS OR TERMS IN THIS DOCUMENT AND THE MEMORANDUM, THE MEMORANDUM SHALL CONTROL. THESE SECURITIES SHALL NOT BE OFFERED OR SOLD IN ANY JURISDICTION IN WHICH SUCH OFFER, SOLICITATION OR SALE WOULD BE UNLAWFUL UNTIL THE REQUIREMENTS OF THE LAWS OF SUCH JURISDICTION HAVE BEEN SATISFIED. THIS DOCUMENT IS NOT INTENDED FOR PUBLIC USE OR DISTRIBUTION. WHILE ALL THE INFORMATION PREPARED IN THIS DOCUMENT IS BELIEVED TO BE ACCURATE, HCM MAKES NO EXPRESS WARRANTY AS TO THE COMPLETENESS OR ACCURACY, NOR CAN IT ACCEPT RESPONSIBILITY FOR ERRORS, APPEARING IN THE DOCUMENT.

AN INVESTMENT IN THE FUND IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. OPPORTUNITIES FOR WITHDRAWAL/REDEMPTION AND TRANSFERABILITY OF INTERESTS ARE RESTRICTED, SO INVESTORS MAY NOT HAVE ACCESS TO CAPITAL WHEN IT IS NEEDED. THERE IS NO SECONDARY MARKET FOR THE INTERESTS AND NONE IS EXPECTED TO DEVELOP. AN INVESTOR SHOULD NOT MAKE AN INVESTMENT, UNLESS IT IS PREPARED TO LOSE ALL OR A SUBSTANTIAL PORTION OF ITS INVESTMENT. THE FEES AND EXPENSES CHARGED IN CONNECTION WITH THIS INVESTMENT MAY BE HIGHER THAN THE FEES AND EXPENSES OF OTHER INVESTMENT ALTERNATIVES AND MAY OFFSET PROFITS.

THERE IS NO GUARANTEE THAT THE INVESTMENT OBJECTIVE OF THE FUND WILL BE ACHIEVED. MOREOVER, THE PAST PERFORMANCE (IF ANY) OF THE INVESTMENT TEAM SHOULD NOT BE CONSTRUED AS AN INDICATOR OF FUTURE PERFORMANCE. ANY PROJECTIONS, MARKET OUTLOOKS OR ESTIMATES IN THIS DOCUMENT ARE FORWARD LOOKING STATEMENTS AND ARE BASED UPON CERTAIN ASSUMPTIONS. OTHER EVENTS WHICH WERE NOT TAKEN INTO ACCOUNT MAY OCCUR AND MAY SIGNIFICANTLY AFFECT THE RETURNS OR PERFORMANCE OF THE FUND. ANY PROJECTIONS, OUTLOOKS OR ASSUMPTIONS SHOULD NOT BE CONSTRUED TO BE INDICATIVE OF THE ACTUAL EVENTS WHICH WILL OCCUR.

ANY PROJECTIONS, MARKET OUTLOOKS OR ESTIMATES IN THIS DOCUMENT ARE FORWARD LOOKING STATEMENTS AND ARE BASED UPON CERTAIN ASSUMPTIONS. ANY PROJECTIONS, OUTLOOKS OR ASSUMPTIONS SHOULD NOT BE CONSTRUED TO BE INDICATIVE OF THE ACTUAL EVENTS WHICH WILL OCCUR.