**PINCHOT LANE PARTNERS, L.P.**
140 W. Franklin Street, #222
Chapel Hill, NC 27516

January 22, 2018

To My Partners:

Some of you have heard me talk about starting an investment partnership for many months now, and I'm pleased to say that it's finally open for business. I appreciate your patience but more importantly, I appreciate the trust that you've placed in me to manage your hard-earned assets. Rest assured that my relationship with limited partners is of utmost importance and that your trust and belief in the Pinchot Lane Partners' investment approach is never taken for granted.

I apologize in advance for the length of this letter but since it is the first one you are receiving as a partner in the fund, I thought it would be a good opportunity to explain my background, investment philosophy, what you should expect of me, some ground rules and finally, a few observations about the market.

**Why I started this fund**

Several friends and family members have asked me at various points to invest a portion of their savings. It felt like a lot of responsibility and in those earlier days, I was not ready to manage outside capital. The immediate years after leaving my last corporate job in 2010 were a time of decompression, travel, and the beginnings of indulging a long-held interest in the public stock markets. As I transitioned from private equity to the public markets, I discovered a steep learning curve and an altogether different form of investing compared to private equity. It's become conventional wisdom that it takes 10,000 hours to acquire proficiency in a skilled pursuit. Depending on how efficiently one applies these hours, this period of learning can take over 10 years.[1] I did not feel that it was appropriate to be paid during this skill-building phase, no matter what the investment outcome. I'll never stop learning as it relates to investing in public markets, and I doubt there is ever such a thing as total mastery. However, I am now in a position where I feel capable of stewarding outside capital with a steady hand. No doubt, there will always be new tricks to learn and more storms to ride out.

Second, it's always more interesting and satisfying to work with partners on a shared endeavor. Managing money independently can be a solitary pursuit and while I don't imagine my daily routine changing much, extending this work in service of others gives it new meaning and sense of purpose. I think of the fund and my relationship with partners as the embodiment of a long-term value creation philosophy. If I'm able to earn and maintain your trust over the long-haul, I will feel like I've done my part to promote a certain set of values that flies in the face of the instant gratification culture endemic to modern finance. I know that you have a broad set of options when investing

[1] Outliers: The Story of Success, copyright 2011, Malcolm Gladwell

your money; hopefully you will see that the investment "product" I'm offering is quite differentiated from most actively managed funds today.

**What you should expect of me**

As a partner in the fund, you should expect to receive quarterly account balance statements, two semi-annual letters from me, an annual partnership tax statement for your tax filings (prepared by the fund's accountants), and periodic notices to call out specific developments in the portfolio as needed.

When it comes to reviewing the fund's investment performance in my letters to partners, you can expect sober analyses from me with respect to hits and misses. I don't intend to sugarcoat any of my mistakes as in doing so, valuable lessons may go unlearned. I tend to communicate from the "realist" school of telling it like it is, instead of blaming an assortment of other factors that don't include an honest look at my own mistakes. Conversely, good fortunes with respect to investment returns will be treated with relative detachment; either the fundamental thesis was correct, or I got lucky (both would be wonderful, but the first is a requirement for long-term success).

You should know and expect that I have serious skin in this game – the majority of my net worth and the vast majority of my liquid assets are invested in the fund, and for the foreseeable future, I will be the largest partner in the fund by a long shot. The fees and expenses program, detailed in the fund's prospectus, ensures that I do not make a dime of income unless the fund's performance exceeds a 6% annualized return threshold (aka "hurdle" or "preferred return"), with underperformance against the threshold in any given year accruing to the following year's hurdle. There is no salary built into fund fees and expenses (nearly all of which go to pay the fund administrator, accountants, and lawyers, roughly in that order) – I literally only make money when fund performance exceeds the hurdle and in the meantime, eat off of my savings. Furthermore, in the early days (possibly years) of the fund, actual expenses will very likely exceed the fee cap charged to partners, which means fund costs in excess of fees will be paid out of my own pocket. Fortunately, costs tend not to scale with fund size, so the more fund assets under management, the less all of us as partners pay in fees (note the 0.75% fee is a cap, not a mandate) – that's my subtle plug to tell any interested friends and family about an investment in Pinchot Lane Partners.

While having serious skin in the game should give you some comfort that I'm not taking risks with your money that I'm not taking with my own, it is not the only criteria for earning your trust. You should expect more than adequate fund returns, evaluated over the long-term. After all, investment performance is why we're all here. Eating my own cooking is one thing, cooking a meal worthy of serving to others is another.

Lastly, no fund leverage (borrowing) will be used to amplify returns. For those old enough to remember the commercial for Wrigley's Doublemint® gum[2], borrowing against your equity to "double your pleasure" (i.e. returns) is not nearly "double the fun" in a

[2] https://youtu.be/F7hwvWIK1eM

portfolio of publicly traded securities. While companies in the portfolio may use corporate debt to enhance returns on equity, they do so against long-term assets and are not subject to margin calls, unlike a portfolio of publicly-traded stocks. Leveraged investment funds can magnify equity returns, but there is no free lunch – leveraged portfolios can cut extremely deeply into equity returns on the downside to the point of drastically reducing returns or worse, putting a fund out of business.

**<u>Ground rules</u>**
To further manage your expectations and avoid surprises, I thought it would be beneficial to lay out some ground rules for the partnership. I consider the following <u>required reading</u> for all new partners in the fund and will probably refer to this section from time to time in subsequent letters.

1. The concept of a preferred return is not a guarantee of future return; it is a threshold above which incentive allocation is paid to the general partner (me). In years in which performance is below an annualized 6% rate, withdrawals by partners at the end of the year reduce the principal on which the underperformance against 6% is carried over to the following year. In other words, partner principal must stay invested in the fund for preferred return thresholds to carry over to the following year.
2. Partners in the fund will be required to pay taxes on gains realized in the portfolio and dividend income, to the extent that the net of realized gains/losses and income are positive at the end of the year. Partner tax liabilities in any given year may or may not bear any relationship to the portfolio's reported return, which is based on pre-tax values at period-end market prices. It is not possible to forecast in advance the size of partner tax liabilities from year to year (as realizations depend on portfolio turnover which itself depends on individual company dynamics), though if realizations are meaningfully large in any given year, I will attempt to provide you with advance notice for tax and liquidity planning. The overarching goal is <u>*not*</u> to minimize taxes – it is to maximize long-term, after-tax performance, even if it means partners owe meaningfully large amounts of tax in particular years. In other words, the tax "tail" will not wag the investment performance "dog".
3. Pinchot Lane Partners is <u>*not*</u> a hedge fund. The purpose of the fund is to generate attractive, risk-adjusted long-term returns predominantly through the buying and holding of a fractional share of businesses (i.e. stocks) acquired at attractive prices. I do not intend to manage the portfolio to minimize volatility or fit the fund into certain "style boxes" advanced by contemporary investment literature. If you find it difficult to stomach 20-40% declines in the market, you probably should not be investing in equities.
4. I do not make, nor am I capable of making, general predictions about the levels and direction of stock market indexes. If you have questions for me along these lines, expect an answer that goes something like, "I have no idea."
5. I will consider the fund's performance a success if, over the longer term, we can beat the S&P 500 index with dividends reinvested.

a. During particularly ebullient periods, I don't (and neither should you) expect the fund to outperform the major stock market indexes – it will most likely look like a laggard. There are several reasons for this – value tends to vanish during exuberant bull markets, and a fair amount of the fund's portfolio could be sitting in cash (or cash equivalents) during those heady times in the absence of attractive investments. Doing nothing (i.e. leaving a fair bit of the portfolio invested in nothing other than cash) is always an option. In the absence of identifiable value, we won't let "excess" funds burn a hole in the fund's pocket.
b. In declining markets, I would expect the portfolio to perform better than the overall index (even if it is in the red), based on a continual orientation toward investing conservatively with a margin of safety. I can't say that I'm excited for the day markets take a tumble, but when (not if) they do, it will be a true test of which market participants are "swimming naked".[3]

6. For the avoidance of doubt, I think of long-term as a period of five years or more. If I can't beat the S&P 500 with dividends reinvested over such a period, we'll all need to find somewhere else to invest our money.
7. As stated earlier, given the fact that the vast majority of my liquid net worth is invested in the fund, it is intended to be managed conservatively. But what does "conservative" mean in this context and relative to performance expectations in up *and* down markets? I'd fail to provide a better explanation than what Warren Buffett said in his partnership letters (c. 1957-1969) under recurring sections titled "*The Question of Conservatism*" (see attached Exhibit A).
8. As a general rule, you should not expect me to disclose or discuss details of investment positions in any given letter or at any given time. The fund may take (or exit) positions in thinly traded companies, where market prices are highly sensitive to relatively low traded volumes. In these cases, it is particularly important not to have a unique investment thesis widely known.

**Taxes and the portfolio at inception**

A further note on taxes – the fund's portfolio at inception is comprised of publicly traded securities that have been contributed from my prior individual account and include embedded gains which are taxable upon disposal. As a new partner to the fund, you are not responsible for taxable gains incurred in these specific positions prior to the fund's inception date. You will, however, be liable for taxes on incremental gains and income realized in these contributed securities after the fund's inception – think of the prices of these securities on the inception date as your cost basis in the fund's opening portfolio).

[3] *"It's only when the tide goes out that you learn who has been swimming naked."* – Warren Buffett

**<u>Parting thoughts (for now) and general stock market observations</u>**

It's worth deconstructing the major factors of economic growth to understand what drives long-term total equity market returns:

- Foundational drivers
  - Underlying real economic growth
    - Population growth
    - Productivity
  - Inflation
  - Dividends
- Kickers
  - Profit margins
  - Capital structure/leverage
  - Long-term "risk-free" interest rates

**Foundational drivers**

In the U.S., generally speaking underlying real (before price inflation) economic growth drivers have been and continue to be muted. Population growth in this country has moderated following a post-WW II "baby boom," from a range of 1.2-1.4% down to 0.7% in 2016.[4] Productivity growth, a measure of economic output per labor hour worked, has also slowed since peaking in the late 1990s and early 2000s.[5] These factors combine to form a backdrop of lower economic growth, in real terms.

Why is this important? If the economy were modeled as an internal combustion engine, population would be like the number of cylinders in our engine, with productivity being the efficiency of the engine in converting energy released from combustion into mechanical energy. The fewer cylinders in the engine and the lower its efficiency, the less energy output in the form of motion. Likewise, lower population growth and productivity generate lower real economic growth.

The rate of inflation, a measure of general prices for goods and services in the economy, has also remained at relatively low levels when judged against the last several decades[6], with hypotheses ranging from competition from Chinese exports, fracking for oil, and internet price disruption.

Dividends are what companies choose to pay out of net profit to shareholders in cash. Once upon a time it was generally accepted that companies should pay out a majority of after-tax profits to shareholders because, like bondholders, shareholders relied upon stocks for income. Gradually, a reinvestment-for-growth mentality took hold (fueled in part by the liberal use of management stock options), leading to a steady decline in the S&P dividend yield to around 2% in modern times.

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[4] https://data.worldbank.org/indicator/SP.POP.GROW?locations=US

[5] https://www.bls.gov/opub/btn/volume-6/below-trend-the-us-productivity-slowdown-since-the-great-recession.htm

[6] https://data.bls.gov/timeseries/CUUR0000SA0L1E?output_view=pct_12mths

Over the long-run, equity market returns can be expected to approximate the sum of underlying real economic growth + inflation + dividends.  Without splitting hairs, forward expectations for each of these figures coincidentally come up all "2s" at present, resulting in a foundational expected long-run equity return of 6% annualized.

**Kickers**

Kickers are factors that change the distribution and thus, the rate of economic growth between different constituent parts.

Let's start with profit margin.  Profits reflect revenues less all costs, including costs for line items like raw materials, energy, labor, equipment, and taxes.  Over the long run, if these costs grow more slowly than revenue, profits end up taking more share of economic output (revenues).  To take a simplified example, imagine a little girl, Susie, operating a lemonade stand.  Susie enlists her friends to make beverages, paying them a quarter per cup while she sells them for a dollar to passing customers.  People love the lemonade and are willing to pay higher prices for it, so she obliges and hikes prices by fifty cents.  Her friends toiling behind the stand, hands numb from squeezing lemons, chime in and ask for a raise.  In a particularly despotic move, Susie denies their request, threatening to fire them and find new friends if they complain further.  And just like that, Susie's profits have increased by fifty cents a cup (after which she files with the SEC to go public on the NASDAQ).  Her revenues grew but her costs of production did not. With profit margins of U.S. companies at all-time highs, this analogy is not as farfetched as it might seem.

Capital structure over time matters, too.  Keep in mind that equities are just one way to finance a company, similar to how a family can finance a home purchase using "all cash," or go the more standard route of "20% down."  Debt is the other primary instrument of finance.  Mortgages and other forms of debt typically charge a fixed or quasi-fixed rate of interest.  In a simple case of a company financed solely through equity and debt, pre-interest expense and pre-tax profits (commonly referred to as Earnings Before Interest and Taxes or "EBIT"), get allocated to paying interest on debt with the leftover portion flowing to equity.  Going back to Susie's lemonade stand, with debt standing in as Susie's poor friends, when EBIT profits grow, profits flowing to equity grow faster because debt payments stay fixed.

Finally, and perhaps most importantly are long-term "risk-free" interest rates.  "[These] act on financial valuations the way gravity acts on matter: the higher the rate, the greater the downward pull."[7]  The rates of return required for different types of investments are benchmarked to the risk-free rate earned by government securities, like 10-year Treasury notes.  If interest rates earned by such securities are at historical lows (as they are now), the hurdle for all other investments is lower as well, and hence their prices rise relative to their source of returns (e.g. earnings), leading to higher P/E ratios. The opposite is also true, if risk-free rates rise, returns required from other investments rise as well, and their prices subsequently decline (all other factors being equal).

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[7] Fortune, "*Mr. Buffett on the Stock Market*," November 22, 1999

**And the kickers were good**
Why does it seem like equity market returns have been well above the foundational 6% annualized level in recent memory? The short answer is, a gradual reduction in long-term risk-free rates (down to unprecedented lows post the Great Recession of 2008) as well as a structural rise in corporate profits as a % of economic output (GDP). These kickers, more than capital structure/leverage levels (which have remained relatively consistent over a long period of time), have largely contributed to equity market returns in excess of what would be predicted by foundational drivers, which themselves have not meaningfully changed for well over a decade.

**The bottom line**
Overall long-run market returns converge to earnings growth + dividends in the absence of influences from kickers. Kickers (chiefly risk-free rates and profit margins) have brought long-run annualized market returns to nearly 10%. You might be thinking, "Not bad, my bank's CD only pays me 2%! I'm all-in!" However, it's worth looking more closely at long-run trends in risk-free rates. For instance, the yield on the 10-year Treasury note currently stands at 2.6%[8], not far from an all-time low. I'm not a bond trader but if I were, I wouldn't bet on rates going much lower. What about corporate profit margins? Sure, they can keep going higher, especially with a one-time pop from lowered tax rates. But to assume that they go higher in perpetuity would be folly. At some point, Susie's workers revolt. And before too long, the government has to address its ballooning debt as a % of GDP. Cutting the size of government down to smithereens (the thought itself enough to make the GOP tremble with excitement) is hardly an option when fully ¾ of federal spending is devoted to social security, unemployment & labor, health care, and the military (not that we can't spend more efficiently against these programs).[9]

**Where that leaves us**
As a reminder, I don't make predictions. The S&P 500 with dividends reinvested has returned 15.4% on an annualized basis in the nine years since the end of 2008. Taking out roughly 2% of annual dividend return[10] leaves you with annualized returns of a bit more than 13%. Further removing 2% annual inflation gets you to 11% real earnings growth, assuming no change in average P/E multiple. If you're still reading this, projecting that figure to continue at such a pace would be an enormously bold bet for an economy that has averaged 2% real growth since 2000[11]. Eventually, returns must be anchored in economic reality. And while a significant acceleration in real GDP growth is being cheered by the same folks who brought you lower tax rates, I'll believe it when I see it.

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8 https://fred.stlouisfed.org/series/DGS10

9 https://www.nationalpriorities.org/budget-basics/federal-budget-101/spending/

10 https://www.investopedia.com/articles/markets/071616/history-sp-500-dividend-yield.asp

11 https://fred.stlouisfed.org/series/A191RL1A225NBEA

What makes me think that the fund can outrun these fundamental laws of the economic universe, when an abundance of smart competition has tried and failed? While there is no “silver bullet” for beating market indexes, an investment strategy that has worked consistently over the long-term is to buy assets at attractive prices and hold them for a while. The monumental challenge is in being able to select the right assets based on thorough knowledge and good judgment, buy them at bargain prices and exercise the patience, diligence, and discipline required to generate attractive returns. In all situations, margin of safety is my guide, where “you have to be a little right to make a lot of money and a lot wrong to lose a little bit of money.”[12]

You will receive the next letter from me in July 2018. Until then, please feel free to reach out if you have questions (other than about stock market predictions).

Sincerely,

Drew Peng

12 https://www.bloomberg.com/news/articles/2015-04-10/hedge-fund-manager-curtis-macnguyen-has-something-to-prove, Bloomberg News, April 10, 2015

## Exhibit A

**"The Question of Conservatism," excerpted from the Buffet Partnership Letters**
Warren E. Buffett

*January 24, 1962*

The above description of our various areas of operation may provide some clues as to how conservatively our portfolio is invested. Many people some years back thought they were behaving in the most conservative manner by purchasing medium or long-term municipal or government bonds. This policy has produced substantial market depreciation in many cases, and most certainly has failed to maintain or increase real buying power.

Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities almost regardless of price-earnings ratios, dividend yields, etc. Without the benefit of hindsight as in the bond example, I feel this course of action is fraught with danger. There is nothing at all conservative, in my opinion, about speculating as to just how high a multiplier a greedy and capricious public will put on earnings.

You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. In many quarters the simultaneous occurrence of the two above factors is enough to make a course of action meet the test of conservatism.

You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason.

I might add that in no way does the fact that our portfolio is not conventional prove that we are more conservative or less conservative than standard methods of investing. This can only be determined by examining the methods or examining the results.

*January 18, 1965*

Truly conservative actions arise from intelligent hypotheses, correct facts and sound reasoning. These qualities may lead to conventional acts, but there have been many times when they have led to unorthodoxy. In some corner of the world they are probably still holding regular meetings of the Flat Earth Society.

We derive no comfort because important people, vocal people, or great numbers of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought. When we really sit back with a smile on our face is when we run into a situation we can understand, where the facts are ascertainable and clear, and the course of action obvious. In that case – whether conventional or unconventional – whether others agree or disagree – we feel we are progressing in a conservative manner.

The above may seem highly subjective. It is. You should prefer an objective approach to the question. I do. My suggestion as to one rational way to evaluate the conservativeness of past policies is to study performance in declining markets.