PINCHOT LANE PARTNERS, L.P.
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July 21, 2018

To My Partners:

1H 2018 Performance Summary

For the first half of 2018 since inception date of January 22, 2018, Pinchot Lane Partners LP ("PLP", the "Fund") returned -1.9%, net of 0.3% in management fees. Below is a summary of Fund performance to date. I've included a column for the performance of "ACP units," which show returns of my personal stake in the PLP portfolio since January 1st compared to the S&P 500 index. The purpose of showing this column is simply to demonstrate what Fund performance would have been, had the Fund started on January 1st.

	Calendar Year-to-date thru 6/30/18	Fund Inception* thru 6/30/18
(1) Pinchot Lane Partners LP Units**	*N/A*	*-1.9%*
ACP partner units**	*6.7%*	*-1.9%*
(2) Benchmark: S&P 500 incl dividends	*2.7%*	*-2.3%*
Relative Performance (1) - (2)	***4.1%***	***0.3%***

** Fund inception was 1/22/18*
*** Net of YTD management fees*

As I've mentioned previously, managing the Fund for short-term performance against benchmarks is not important to me and not part of my investing approach. Nonetheless, I do believe in complete transparency, so a letter without a comparison to the Fund's benchmark would be incomplete. The highest priority we should all have as investors in the Fund is long-term compounded performance in excess of our benchmark, the S&P 500 index including dividends.

In an effort to help you understand what the partnership owns, shown below are the top five positions in the Fund as of June 30, 2018, including descriptions and brief summaries of investment theses:

Name	Symbol	Description	Investment Thesis	% of Portfolio Value	Date of initial investment
CyrusOne	CONE	Rapidly growing provider of domestic datacenters serving enterprises and hyperscale cloud companies	Company has developed the fastest, lowest-cost development approach and secured land in the most attractive datacenter markets (e.g. NoVA, TX, PHX); leveraging design and development expertise to expand platform to Europe; strategic relationship with largest Chinese DC player	12.2%	Aug-2013
Viasat	VSAT	Provider of satellite equipment and communication services for government/defense sector, consumer broadband, and commercial aviation	Lowest cost satcom provider on critical cost per bit capacity metric; technology is years ahead of primary competitors; potential to become first truly global internet service provider post-launch of next-generation, advanced Viasat-3 satellite constellation (currently in construction)	9.3%	Jun-2012
Expedia	EXPE	Global online travel platform selling airfare, accommodations, and attractions	Global OTA platforms have consolidated to two large players (Booking Holdings being the other one); EXPE pursuing international growth and rapidly growing alternative accommodations segment, with ample opportunity to improve bottom line cash flow margins	9.0%	Oct-2017
Alphabet	GOOG / GOOGL	Leading global search, advertising, mobile, and media platform with increasing presence in enterprise cloud, consumer devices and autonomous vehicles (AV)	Enormous growth opportunities in core product/service segments as well as emerging businesses (cloud, devices, AV); trades at a reasonable valuation relative to cash flows and future opportunities	8.4%	Nov-2011
Fiat Chrysler	FCAU	Global passenger vehicle manufacturer that owns Jeep, RAM, Alfa Romeo, Maserati, Fiat, and Chrysler brands as well as several components/parts businesses	Company is completing a five-year transformation plan that has improved margins substantially and reinvigorated global growth brands with new models and architectures; next five-year growth plan shows promise to continue improving profitability while driving growth behind key franchises; equity trades at a mid-single digit P/E multiple with strong balance sheet	8.0%	Dec-2016
			Total Top 5	**46.9%**	

Positions earn their places in the portfolio based on their potential for risk-adjusted returns. In a perfect world, a fund manager would know the precise returns available for each position in the portfolio, and size them accordingly. In reality, the best one can hope for is to value assets roughly, ensuring ample margin for error so that if actual results fail to converge to expectations, permanent losses of capital can be avoided. Furthermore, business and market conditions change constantly, due to factors both in and out of the control of company management – for the latter, imagine a beachfront hotel that encounters a once in a century hurricane. For these reasons, attempting to be exact is a futile exercise; the best approach is to apply sound reasoning and intelligent analyses to a sufficiently comprehensive set of correct, available evidence.

Another noteworthy point in the table above are the dates at which these positions initially entered the investment portfolio. The length of time most of these companies have been held demonstrates a core principle of the PLP strategy, which is to maximize risk-adjusted, after-tax returns over the long-term. In holding positions for years instead of days, weeks, or months, partners minimize taxes on capital gains. More importantly, holding over the long term allows investment theses to play out and enables superior business models to compound value at attractive rates.

On the other hand, we do have to turnover positions in the portfolio from time to time due to assets reaching full valuation, the diversion of capital to ideas with higher risk-adjusted returns, partner redemptions, and investment theses not playing out the way I expected (aka being wrong).

Between January 26 and February 8, the S&P 500 index was down over 10%, mostly in a straight line. During this period of precipitous declines, the Fund took advantage of market volatility to incrementally add to several core positions at attractive prices. It's difficult to come up with credible reasons for the behavior of the market, but given our long-term orientation, it's not important to do so. What is important is to act when such opportunities present themselves. In the eternal wisdom of Warren Buffett, "Be fearful when others are greedy, and greedy when others are fearful."

Good Investing Can (and often should) Be Boring

The popular quote about fighting wars or flying planes being like "interminable boredom punctuated by moments of sheer terror" also applies to fundamentals-based investing. Terror is too strong a term when used in the investing context, as moments can be full of fear, joy, or a mixture of both. Unlike day trading and momentum-driven strategies, PLP generally employs a rather boring, plain approach to investing. This approach begins with curiosity and awareness, a keen desire to spend a good portion of each day learning new things, and the willingness to carefully hone an investment thesis for as long as it takes. Good investment ideas are as rare as white tigers, so patience and persistence are paramount.

As an investor and portfolio manager, the goal of each day is really to grind out small victories in terms of sharpening our investment "edge," while being prepared to "strike while the iron is hot." I'd like for the management teams leading companies we invest in to embrace a similar approach, focusing on the game as it evolves on the field and fortifying corporate strategies and defenses, instead of being transfixed by the action on the scoreboard.[1] Embracing such an approach enables the Fund to react swiftly and decisively during periods of momentary chaos.

Secrets of Value Investing

> "The real secret to investing is that there is no secret to investing. Every important aspect of value investing has been made available to the public many times over, beginning in 1934 with the first edition of *Security Analysis*. That so many people fail to follow this timeless and almost foolproof approach enables those who adopt it to remain successful. The foibles of human nature that result in the mass pursuit of instant wealth and effortless gain seem certain to be with us forever. So long as people succumb to this aspect of their natures, value investing will remain, as it has been for 75 years, a sound and low-risk approach to successful long-term investing."
>
> *– Seth Klarman (Baupost Fund), The Timeless Wisdom of Graham and Dodd, Preface to the Sixth Edition of Security Analysis, ©2009.*

Good, fundamentals-based investing is mostly the consistent, assiduous application of common sense principles within a continually shifting landscape of opportunity. It is not preoccupied with hidden secrets or strokes of genius. Or, as Charlie Munger states below, investing success is typically found "trying to be consistently not stupid." While good value investing may be boring, it's never dull.[2]

> "It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent. There must be some wisdom in the folk saying, 'It's the strong swimmers who drown.'"
>
> *– Charlie Munger*

<u>On Tariffs</u>

Trade tariffs and the intention of the Trump administration to use them to level the playing field in certain domestic industries (many concentrated in districts that voted for Trump) are an issue that has been widely blamed for volatility in global markets throughout the first half of 2018. This administration has already followed through on tariffs for imported solar panels, Canadian lumber and paper, washing machines, steel and aluminum, and $34 billion worth of Chinese goods (with an additional $200 billion under review). While it is important to note that tariffs have been used by prior administrations (under Obama, there were tariffs for solar panels, Chinese tires, Asian steel, and Canadian paper), the scale, breadth, and aggressiveness of the Trump tariffs (both levied or threatened) seem unprecedented in the modern age. As an example, the US imports approximately $500 billion[3] of Chinese goods each year, and the most

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[1] *"Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard."* – Warren Buffett

[2] "Three Uncelebrated Edges," The Reformed Broker, May 18, 2018

[3] https://www.census.gov/foreign-trade/statistics/product/enduse/imports/c5700.html

recent threats propose duties on an additional $400 billion of them, covering basically all of the products bought from our largest trading partner. Meanwhile, several of our major trading partners in the rest of the world have enacted or threatened retaliatory tariffs on US exports. The math to reasonably estimate the impact on global businesses and economies from tariffs is complicated (with dynamic near and long-term consequences), but the net of it is that prices to consumers of traded products will increase, as import duties act as taxes that raise the prices of goods purchased. If you've recently tried to buy a washer and dryer or a house, you've probably noticed. Preliminary estimates of the impact on US employment and GDP by TaxFoundation.org suggest a loss of 365,000 jobs and a 0.5% reduction in long-run GDP, which they've calculated will reduce the long-term benefits of the Tax Cuts and Jobs Act (enacted in December 2017) by one quarter[4].

While unfettered free trade with no thought or consideration for responsible business practices and labor welfare is not the answer, tariffs are blunt instruments that cannot replace more lasting solutions to issues of competitiveness and productivity. At one point we had onerous tariffs on shoes imported to the US[5], but those didn't stop the eventual shift of shoe production almost entirely to foreign countries (fun fact: 98% of all shoes sold in the US are produced overseas[6]). Steel tariffs enacted by George W. Bush in 2002 were acknowledged by experts to have cost more American jobs than they saved.[7] Tariffs are not the solution for long-term American competitiveness and in many cases, simply postpone the inevitable. The good news is that American industry and labor have historically been successful adapting to changing business conditions. Though no comfort to the displaced shoemaker, in the long run our economy has found ways to be better off. In the interim, we need programs that assist workers rendered uncompetitive through global market forces, a role that can only be served by government (who else?).

As it relates to impacts on the PLP portfolio (which takes more concentrated as opposed to economy-wide bets), the evolution of tariffs is something that I watch carefully to understand the issues they may pose for portfolio companies.

A Word on Fees

The performance fee (aka "incentive allocation") structure for PLP may seem unorthodox in the world of actively managed, performance-oriented funds. I didn't choose it to be contrarian, just to be more fair to Fund investors. Most hedge funds earn incentives for any dollar of positive performance, in addition to hefty management fees. Industry standard fees tend to be in the "2 and 20" range, named after the percentage of assets under management (AUM) paid out for management fees and the percentage of any profits reserved for fund operators, respectively. Perhaps it's easier

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[4] https://taxfoundation.org/tracker-economic-impact-tariffs/

[5] Somewhat related, highly recommended book: *Shoe Dog*, by Phil Knight (co-founder of Nike)

[6] https://www.cnbc.com/2018/04/06/americans-are-already-paying-tariffs-on-clothing-and-shoes.html

[7] https://www.politico.com/story/2018/03/07/steel-tariffs-trump-bush-391426

to calculate a limited partner's share of fees with this arrangement, but I assure you that it's anything but aligned with limited partner interests.

PLP is intentionally structured for fairness to both general (me) and limited (you) partners and adopts a fee scheme that rewards me for performance only above a hurdle rate of 6%, subject to a high water mark after periods of underperformance against the hurdle. In contrast to most actively managed funds, I do not earn a penny of incentive compensation until I clear the hurdle. The theory behind a 6% hurdle is that (as explained in my inaugural letter to partners) simply going long the American economy over an extended period of time can be expected to yield a 6% annualized total return.

High management fees are also problematic in that they are paid to fund operators regardless of performance and can generate meaningful profits when they exceed fund expenses. At least in the case of performance fees, if there's no performance, there aren't any fees. However, management fees pegged at 1.5-2% of AUM are like death and taxes – sure things, which is why most active managers with highly profitable management fee structures love them and are loathe to give them up. With fees like these, it's easy to see why fund managers who use them gravitate toward the "asset gathering" game, favoring an active sales and marketing effort to attract larger amounts of investor capital over actually having to earn their income through superior performance.

I'd encourage each of you as partners to think carefully about whether fees are justified for other investment products you may be evaluating, especially for the "hot products" that people like to talk about at cocktail parties and kids' birthdays. I say this as a former private equity professional – it's highly debatable whether the fees in *<u>most</u>* of the active investment management universe are actually worth it.

A great research document summarizing zero/low management fee fund structures and hurdle-based performance fees compiled by Mark Chapman (a director of Guy Spier's Aquamarine Fund) can be found here.

<u>Additional Capital Contributions</u>

As communicated in the memo sent to partners on June 12, 2018, I personally made an additional $100,000 investment in the Fund effective July 1, 2018 in response to new opportunities to deploy capital into assets at attractive prices. As a reminder, limited partners have the opportunity to invest additional capital on January 1st and July 1st of each year. *Given that we are in the early stages of growing the Fund, any existing partners who would like to invest additional amounts may do so effective on the 1st of each month, although it is critical for the Fund to receive deposits (via wire or check) at least two weeks in advance*. To make the Fund's accounting easier, additional contributions can be made whenever convenient, but won't be priced into partnership units until the following month-end. As I said in my January letter to partners, I'd like to grow the partnership assets so that management fees can eventually be reduced below the 0.75% annualized cap. Costs (which <u>do not</u> include any salary or wages for me) are relatively fixed, so the larger our Fund grows, the less each of us as partners will need to pay as a percentage of assets for fund administration, accounting, and legal overhead. Currently, actual fund expenses exceed capped management fees (with the balance coming out of my pocket). If you have friends and family with capital to invest who share the fund's long-term investment philosophy, send them my way (drew@pinchotlane.com).

In Closing

This letter has gone on longer than I initially expected so if you've gotten this far, a congratulations is in order. Your time and attention are greatly appreciated. The markets have certainly offered some "terror" in the short time that the Fund has been operational, which shakes me out of my industrious, boring routine and provides the opportunity to test my convictions. Occasionally, these moments offer attractive openings to find value, which highlights the importance of having capital available to deploy quickly. The Fund is nowhere close to exhausting capacity in its primary strategy of finding underpriced, reputable equities trading in major global markets.

You will receive the next partner letter from me in January 2019. As always, please feel free to reach out if you have comments, suggestions, or questions on anything that is unclear. Hopefully, I will see many of you in person before then.

Sincerely,

Drew Peng