Arquitos Capital Management

July 19, 2017

> The coziest spot is under the warm blanket of ideology. It offers easy answers to difficult problems. But, man, is it dangerous, especially in an adapting world. Great stuff happens at the intersection of "Confident enough to take a stand" and "Humble enough to admit when something I don't want to be true is true."
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> *Morgan Housel*

Dear Partner:

Arquitos Capital Partners returned 5.5% net of fees and expenses in the second quarter of 2017, bringing the year to date return to 24.1%. Our annualized net return since the April 10, 2012 launch is 30.6%. Please see page five for more detailed performance information.

The quote above is from a great blog post, "What I Believe Most," by Morgan Housel. The entire post is great. The most successful investors have a unique ability to combine confidence and humility. They have to have the confidence to make the decision to buy and sell a stock when their opinion differs from the collective wisdom of the crowd (i.e., the current share price), and they have to have the humility to realize that most of the time the crowd is right.

Getting that proper balance is very difficult, especially in times of market stress. It is even harder to consistently maintain the proper mental equilibrium for effective decision-making. This is why being self-aware and intellectually honest are the two most important traits to reduce risk. If your initial reaction to stress is to deflect rather than internalize, it is going to be tough to be objective with yourself.

I'd like to address the subject of risk in this letter. This is a topic that is a lot easier to talk about when you've racked up a few good quarters in a row! This also is probably the most important time to do so. Lessons tend to take hold better when you are receiving negative feedback from your poor decisions. Real risks grow when all seems well.

Let's get this foundational question out of the way: What is risk? The answer is that risk is the probability of permanent capital loss.

The chance of the price of a stock going down and the chance of the performance of the portfolio going down is not risk. Rather, risk in this context is not being able to psychologically handle a short term decline. By short term I mean less than a few years. Ignore your monthly, quarterly, and even annual returns. Look at them over a three to five year period. Your life will improve.

Because risk is the probability of permanent capital loss, I am confident enough to take the stand that the assessment of risk must be qualitative, not quantitative. How do you quantify someone's nerve? How do you quantify a portfolio manager's willingness to take on limited partners who don't share a similar time horizon? How do you quantify an investor's inability to buy a company without a sufficient margin of safety?

Answers to those questions are going to be fuzzy and up to the judgment of the decision maker. Clearly they can't be numerical. I studied political science as an undergrad. What I learned is that political science, of course, is not a science. Economics is not a science. Investing is certainly not. It is an art, and so is the proper management of risk. Assessing and mitigating risk is about judgment, not numbers.

I submit that believing you can quantify risk, in fact, creates risk itself! Quantitative risk measurements, the specificity of which can't possibly be accurate, primarily serve to fool the believer.

People who come up with a number to define the risk of a stock or the risk to a portfolio really can sound smart though. It pays to remember that our goal is to *actually* reduce our exposure to long term loss of capital, not simply create the *perception* that we reduced this risk.

There are no immutable truths to quantify risk. There are, however, immutable truths to reduce risk: Limit leverage, have a large margin of safety, know your investment well, and honestly monitor your psychological state. More on each:

> **Leverage.** Debt increases risk. The easiest way to reduce your risk is to not have leverage, especially margin leverage, in your portfolio. Margin leverage is one of the few ways that you can be correct in your investment analysis, and ultimately in the result, but still lose money. It's not worth it.
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> The second easiest way to reduce your risk is to not invest in companies that have excessive leverage. Having excessive debt on a company's balance sheet can lead to problems. Having excessive debt also limits opportunities. One of the key components to the "Balance sheet to income statement investing" that I advocate is the ability for a company to take on debt when they see an unusually attractive opportunity. Better to buy a company with little debt and a strong balance sheet that can use that strength to safely take advantage of those opportunities by adding a reasonable amount of debt. They can't do it if they are already overleveraged.
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> **Margin of safety.** Let's go to Michael Mauboussin quoting Warren Buffett, "We believe the best and most practical way to restate the margin of safety concept is to think about discounts to expected value. The combination of probabilities and potential outcomes determine expected value."

Says Buffett, "Take the probability of loss times the amount of possible loss from the probability of gain times the amount of possible gain. That is what we're trying to do. It's imperfect, but that's what it's all about."

A large margin of safety is helpful for many reasons. One, it gives you the opportunity for outsized gains. Two, it mitigates the effects of mistakes in analysis. And three, it helps protect against unknowable and unforeseen market and company-specific stresses.

Know your investment well. In order to know if you have a margin of safety, you must know your investment well enough to roughly determine its intrinsic value. Or, if you want to take the Mauboussin approach, determine the expected value.

Clearly you must have the skillset to analyze a company. You also have to have the humility to recognize that the intrinsic value cannot be determined for some, perhaps most, companies. Other times the intrinsic value can be determined, just not by you. There is no shame in having a "too hard" pile. Mine is high.

I am attracted to companies where there are a low number of variables that are at least somewhat measurable. This is easier to do if you are relying on a company's balance sheet rather than their income statement. It is also far easier for a company to manipulate their income statement, so this approach has the added benefit of higher predictability.

Some investors believe that just because a company is small, it is more risky. This isn't true. Those investors think that because a stock price moves more rapidly, a stock is more risky. They're mistaken. Intelligently investing in smaller companies can dramatically reduce your risk. Most of the least risky companies I have invested in have been small. They were not risky specifically because of their low price relative to their actual value. They also were much easier to analyze.

Temperament. Here is where the self-awareness and Intellectual honesty fit in. This is a never-ending process and it is not easy. Nearly every investor, including the best, have succumbed to the market's excitement and depression at one point. I don't think it makes me a hippy to say that it is vital to protect your psychological wellbeing. Effective analysis consists of thousands of small judgments while researching a company. It's a big risk if you can't make those judgments with a clear head.

This is also where ideology can blind you, and being blind as an investor is a dangerous thing. An investor always has to be mentally prepared to the idea that he is wrong, and if so, be willing to change his opinion.

The reason that you pay a hedge fund manager the fees that you do is for him find situations where the risk is low and the potential gains are exponentially high. When a portfolio manager is confronted with

an opportunity like that, he has to have two thoughts: First he has to be certain, then he has to be aggressive. This is a rare event and it is a mistake of omission to not take advantage of it.

The least risky investment I've ever made was in ALJ Regional Holdings in early 2013 after they sold their subsidiary. I made it 20% of the portfolio at cost. It went up more than 500% in two and half years, though I trimmed the allocation along the way. ALJJ's performance happened despite the fact that the risk of permanent capital loss at that time was a grain of sand above zero.

Thank you for your commitment to the partnership. I look forward to continuing to compound funds on your behalf for many years to come. Here's to more ALJs, Intrawest Resorts, Sitestars, Arctic Glaciers, and others.
Best regards,

Steven L. Kiel
Arquitos Capital Management

Arquitos Capital Partners Performance Compared to the S&P 500

	Arquitos Capital Partners (Gross)	Arquitos Capital Partners (Net)	S&P 500	Arquitos Capital Partners (Net) v. S&P 500
2017 YTD	30.2%	24.1%	9.3%	+14.8%
2016	64.9%	54.9%	12.0%	+42.9%
2015	-13.8%	-14.8%	1.4%	-16.2%
2014	72.2%	57.8%	13.7%	+44.1%
2013	58.2%	46.6%	32.4%	+14.2%
2012*	9.0%	7.2%	4.9%	+2.3%
Cumulative	449.3%	305.7%	96.0%	+209.7%
Annualized	**38.3%**	**30.6%**	**13.7%**	**+16.9%**

*Founded April 10, 2012

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