Arquitos Capital Management

October 23, 2017

Insanity in individuals is something rare - but in groups, parties, nations, and epochs, it is the rule.
Friedrich Nietzsche

Dear Partner:

Arquitos Capital Partners returned 15.4% in the third quarter of 2017, bringing the year-to-date return to 43.1%. Our annualized net return since the April 10, 2012, launch is 32.4%. Please see page four for more detailed performance information.

We welcomed approximately 30 investors to our annual meeting in New York on September 12. It was great to see long-time friends there as well as several new faces. Particular thanks to all who travelled long distances, including from overseas. If you were unable to attend but would like to view the presentation then please let me know. We would be happy to send you a copy.

I discussed several of our largest positions at the meeting: Sitestar, Boston Omaha, Westaim, and MMA Capital. Each is an example of something I call "balance sheet to income statement investing." The idea behind this approach is to invest in companies where the risk of permanent capital loss is low while also retaining the potential for exponential gains.

We have all heard that to get higher returns, we must take on more risk. Fortunately for us, something that is generally true is not always true. My job is to find opportunities where "more risk, more reward" is not true.

How is that accomplished in practice? To start, I am interested in certain balance sheet strength characteristics. I generally am looking for companies with strong cash positions or high amounts of liquid assets with low debt. Sometimes there are off balance sheet assets or tax assets that are not obvious to casual followers. MMA Capital is a good example of a company with these hidden assets.

The risk level for companies with these characteristics is dependent on their share prices. Few trade at a reasonable valuation. This is why it is necessary to have a focused portfolio. There are not 20 companies like this at any given time that are attractively priced. Some observers mistakenly believe that holding fewer stocks is riskier. The opposite is true for this type of investing. Buying a company at an inflated price is the risk, and we don't want to add a holding we otherwise wouldn't own just for the sake of diversification.

In the public markets, there are generally two types of investors: those interested in the balance sheet and those interested in the income statement. I should note here that most people that participate in the stock market are not "investors" in the true sense of the word. It has been my experience that most participants are speculators. I have found this to be true for retail investors and professional investors alike. Professional investors may know more facts about a company and may concoct more elaborate justifications for owning something, but the judgment they employ is often still based on a greater fool theory—the idea that the value of a company is derived from how much someone else would pay for it. That approach is a mistake. More importantly, that approach is risky.

I feel a strong kinship with balance sheet investors. Their first concern is ensuring that the risk of permanent capital loss is low. This is my first concern as well. These investors often analyze companies based on a multiple of book value or net assets. They want a strong balance sheet and a cheap stock price relative to balance sheet characteristics. These balance sheet investors generally look to sell their position when that discount narrows, and that is not a bad approach.

We can do better.

I try to find companies that have those strong balance sheet characteristics and also have the potential for significant earnings power. The key word is potential. By the time that potential is realized, those balance sheet investors are long gone and the income statement investors have moved in and driven up the share price.

The old balance sheet investor is looking for a share price to be below something like book value. The new income statement investor is looking for shares to be worth a multiple of something like free cash flow. That transition process can bring significant gains if we can be patient.

What are some of the balance sheet characteristics that I am looking for? Attractive balance sheet to income statement companies typically have significant reinvestment opportunities. Their managers have strong capital allocation skills. Returns on equity and returns on invested capital are high. They often are owner-operated, where the directors and managers own a significant number of shares. There are often incentives in place that reward cash generation, whether it is a bonus structure, tax loss carryforwards, or engaged directors or large shareholders focused on performance.

Sitestar, Boston Omaha, Westaim, and MMA Capital all fit this mold. I initially invested in each of these companies because of their balance sheet strength. I wasn't alone. Plenty of other balance sheet investors also have been drawn to these four companies over the last several years. Each company is in varying stages of becoming attractive to income statement investors. The balance sheet investor crowd that will hold on for that full transition, as we will, will likely thin out significantly as their share prices go up.

In order to carry out this balance sheet to income statement strategy, it is important that the investing time horizon of our limited partners matches that of the portfolio. Ideally, we are looking for investors with a time horizon in the decades. I understand that is not feasible for some, so I would ask that you not invest in the fund with assets that you will need over the next three to five years. We must give these investments time to play out. That time period can't be measured in months. Month-to-month and quarter-to-quarter performance results are completely irrelevant.

Not every one of our positions is a balance sheet to income statement investment. We have certainly had big gainers through the years from holdings that were not. But this style has been the best way I have found to combine a low risk investment with high potential gains.

Why do opportunities like this arise? I used to think that the market was *mostly* efficient, but not *always* efficient. My opportunity as an investor was to find the inefficiencies and commit an appropriate percentage of the portfolio to it. I am beginning to question whether "mostly" is an overstatement. Certainly, there are areas where the market is efficient. There are also structural reasons for inefficiencies. Jeremy Grantham has discussed the most important reason:

> "The central truth of the investment business is that investment behavior is driven by career risk. In the professional investment business we are all agents, managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority "go with the flow," either completely or partially. This creates herding, or momentum, which drives prices far above or far below fair price. There are many other inefficiencies in market pricing, but this is by far the largest."

That mindset may best describe our advantage. I am not your agent. Legally, perhaps. But that is not how I manage the portfolio. I have no career risk. I don't care what other investors think or do except for how they create investment opportunities for us. I have no interest in "going with the flow."

Of course, I have been, and will be, wrong on occasion. That is an occupational hazard. However, it is far more likely that when I am wrong, I will be uniquely wrong. I take no solace in being wrong (or right) along with everyone else. Misery loves company, but that is a poor way to live.

We are blessed to have a great group of 51 limited partners. Each, to a person, respects our long-term investing approach. I could not successfully carry out this investing strategy without this support. Thank you for your investment. I look forward to continuing to compound funds on your behalf.
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	54.3%	43.1%	14.2%	+28.9%
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	550.9%	368.1%	104.8%	+263.3%
Annualized	**40.6%**	**32.4%**	**13.9%**	**+18.5%**

*Founded April 10, 2012

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Performance returns for Arquitos Capital Partners reflect the fund's total return, net of fees and expenses. They are net of the high water mark and the 20% performance fee, applied after a 4% hurdle, as detailed in the confidential private offering memorandum.

Performance returns for 2017 are estimated by our third party administrator, pending the year-end audit. Actual returns may differ from the returns presented. Positions reflected in this letter do not represent all the positions held, purchased or sold.

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