January 16, 2016

Dear Partner,

Updated results for the Hirschmann Partnership (the “Fund”) are shown below:

| | Class A Return | Class B Return | S&P 500 Index | MSCI World Index |
|---|---|---|---|---|
| Q4 2014 | -2.2% | -2.2% | 4.9% | 1.0% |
| 2015 | 27.0% | 24.8% | 1.4% | -0.5% |
| **Cumulative** | **24.2%** | **22.0%** | **6.4%** | **0.5%** |
| **Annualized** | **18.9%** | **17.3%** | **5.1%** | **0.4%** |

In the first two weeks of 2016, Class A appreciated modestly while the S&P 500 and MSCI World fell 7.9% and 8.5% respectively.

As a reminder, the share classes are identical except for their performance allocation. For Class A, the performance allocation is 25% of the profit above a 6% hurdle rate. For Class B, it is 33% of the profit above the S&P 500 return. Neither has a management fee.

The Fund's patient clients deserve much credit for its favorable performance thus far. Although the Fund’s investments outperformed almost immediately, they were intended as long-term investments and thus risked temporarily underperforming.

One might think the typical investment fund with sophisticated pension fund clients would also be able to make long-term investments. However, pension fund managers often fear being fired if they stick with underperforming investment funds. Hence the typical investment fund greatly fears that short-term underperformance may lead to large client redemptions.

Unfortunately periods of underperformance are inevitable since undervalued securities can always become more undervalued in the short-term. For example, although Warren Buffett’s Berkshire Hathaway has appreciated ~3x more than the S&P 500 over the last 25 years, it has underperformed the S&P 500 in ~40% of those years. Thus, although I remain extremely optimistic about the Fund’s performance over the next five years, we should always be ready to accept temporary underperformance or even declines to earn exceptional long-term returns.

## Market Update

Despite mild declines in equities and junk bonds, most assets continue to seem overvalued and a severe crisis seems likely within a few years. Excess seems everywhere:

- Global private and government debt is far higher relative to GDP than before the 2008 crisis[1] in which high debt nearly caused a depression
- The ratio of global government debt to GDP is at its highest peacetime level ever[2] and thus the risk of government default is high. Yet government borrowing costs are at 5000 year lows.[3] For instance, Spain would have probably defaulted in 2012 if not for an EU

bailout, yet it was recently borrowing at negative rates – the lowest in Spain's 547 year history[4]

- In 2015, the median market capitalization to corporate sales ratio of US stocks, which represent more than half of world stock market value, reached its highest level ever – far above levels reached before the 1973, 2000 or 2008 crashes[5]
- Due to an apparent "triple bubble"[6] in debt, construction and real estate, China, the world's second largest economy, used more cement in the last two years than the US did in the entire 20th century[7]

## The Bond Bubble

Bulls claim central banks (CBs) will keep asset prices high by keeping interest rates low. However, government debt in Japan, Europe and the US is so high that default seems inevitable through extreme inflation or outright failure to pay. For example, over the past 200 years, 45 of 46 of the countries with the US' level of peacetime debt have defaulted.[8] Further, US debt ratios are as high or higher than the 2007 PIIGS' (Portugual, Iceland, Ireland, Greece and Spain), which all required bailouts between 2008 and 2012.[9] If investors wake from their stupor and realize that most government debt is probably junk, rates will soar leading to defaults, lower growth, market crashes and huge government deficits.

Some argue that CBs won't allow government interest rates to rise. Suffice to say, if CBs could always prevent debt crises, Brazil's government bonds would not be yielding 16%, US Treasuries would have not have been yielding 16% in 1981 and most of the more than 100 government defaults in the 20th century would not have occurred. In fact, CBs will probably ultimately make any debt crisis worse because their quantitative easing policies have dramatically increased governments' debt rollover risk by shortening debt maturities.[10]

Others claim rates will remain low because they have remained low since 2009 despite high debt. However, borrowing rates can remain irrational for years before violently correcting (e.g. 1980s Latin American debt crisis, 1997 Asian financial crisis, 2000s housing bubble, etc.).

A market crash doesn't require a major trigger event. There was no Lehman Brothers moment before the stock market crashes in 1929, 1987 or 2000. An overvalued market is analogous to a ruler balanced vertically on a finger; a fall is inevitable due to its unstable position and the trigger (e.g., a tiny breeze or hand movement) is incidental.[11] That said, there are currently no shortage of potential triggers that could send rates soaring (e.g., a recession that reveals governments' financial frailty, a major default that causes investors to reassess risk everywhere, a small bond price decline that turns into an avalanche due to algorithmic trading and reduced broker/dealer market-making, etc.).

If a government debt crisis occurs, it seems likely to trigger far worse inflation than the 1970s Great Inflation. The Great Inflation was ended by record Fed interest rate hikes, which signaled its intention to halt inflation even at the cost of recession and higher government debt. However, government debt in the US, Europe and Japan is far higher now than in the 1970s, so large rate hikes now would probably trigger an outright government default. Thus, if a debt crisis occurs,

CBs would need to let inflation remain high until the real value of government debt had been substantially reduced.

In many ways, the Japanese, European and US governments are similar to failed highly-leveraged financial entities such as Long Term Capital Management, Countrywide Financial and Bear Stearns. Those entities were profitable for years as they borrowed short-term debt to fund long-term assets, such as securities and mortgages. However, when asset prices fell, the entities collapsed as lenders cut off funding. Similarly, the aforementioned governments are heavily reliant on short-term debt. The difference is that, instead of securities or mortgages, governments' long-term assets are future budget surpluses. Unfortunately, lenders' confidence about these future surpluses can suddenly change (e.g., the PIIGS collapse after 2007). Presently markets seem calm because budget deficits seem sustainable due to low government borrowing rates and tax revenues inflated by asset bubbles (e.g., capital gains). But just wait.

## Gold-Linked Securities (GLS)

The Fund has increased its allocation to gold-linked securities (GLS), which are equity-like securities whose value is correlated with gold. This increase seems prudent because:

- Using the Fund's proprietary valuation method, gold remains far below its average valuation over the last 5, 10, 45 and 100 years, despite long-term increases in nominal and inflation-adjusted gold prices. Thus, gold seems highly likely to appreciate over the long-term, and, if it does, the GLS are likely to appreciate by a much greater amount. (To protect the Fund, I am not disclosing the Fund's specific GLS holdings or its gold valuation method.)

- Since the GLS seem extremely undervalued at current gold prices, they seem likely to appreciate even in the unlikely event that gold plunges. As shown in the next section, the Fund's GLS appreciated in 2015 despite a ~12% gold price decline.

- A global government debt crisis seems highly likely and would probably cause at least a 400% gold price increase and an even greater GLS price increase.[12] Further, a bet against the bond bubble should be bigger now than a few years ago because a bubble becomes increasingly likely to burst as it ages.

Since gold's value does not depend on a promise to pay future interest or dividends, it is immune from default, inflation and equity risk. If concern about those risks rises, gold usually rises as it becomes more attractive relative to assets exposed to those risks (e.g., stocks, bonds, loans, real estate, fiat currencies such as the dollar, etc.). In a government debt crisis, gold also usually outperforms cash (e.g., deposits and money-market government debt), which is vulnerable to bank failures and outright government default. During financial crises, the appeal of gold's safety generally dominates the offsetting effect of lower global wealth. Thus, gold rose as global wealth fell during the Great Inflation and the 2008-09 crisis.

For the past 6000 years, gold has been by far the preferred investment for protecting against default, inflation and equity risk (e.g., the current market value of gold investments dwarfs that of silver, platinum, digital currencies, etc.). This reflects its unique combination of rarity, fungibility, easy storage, extreme durability and wide geographic distribution. Although other non-income producing assets may be immune from some of the same risks, they all have major drawbacks: silver tarnishes; platinum is hard to melt; diamonds are not fungible, rare or liquid (i.e., convertible to cash); collectibles (e.g., art, wine, stamps) are fragile, non-fungible, illiquid and vulnerable to fraud; digital currencies are hackable, intangible and vulnerable to new technologies; etc.

Some say gold shouldn't be in a portfolio because it is likely to underperform bonds and stocks over the very long term (i.e. 20 years). However, gold has historically appreciated net of inflation. Further, holding gold is beneficial even if it underperforms because it reduces portfolio volatility caused by default, inflation and equity risk. For example, gold may be the only major asset with a long-term negative correlation with stocks and bonds.[13] Finally, regardless of the very long term, gold seems likely to outperform over the next five years due to its low valuation, the high probability of a debt crisis and the nosebleed valuations of bonds and US stocks.

Some claim gold can't be valued because it doesn't produce income (i.e., cash flow). However, non-income producing assets can be valued – just not with the usual discounted cash flow calculation. For example, the value of fiat currencies (i.e., exchange rates) can be estimated using purchasing power parity (e.g., the Big Mac Index). Income-producing assets can also be valued without using cash flow. For example, the stock market can be valued with the market capitalization to GDP ratio, which is Buffett's preferred method. Regardless, the Fund's proprietary method is a rational way to value gold and would have accurately predicted long-term gold price changes over the past century.

Some argue that gold's value depends on buyer whim, as with collectibles, because gold's industrial uses are insignificant, unlike oil or copper. However, collectibles' price and valuation histories are brief, volatile and/or opaque. For example, there is no consensus on the historical returns from a broadly diversified art collection – if such a collection could even be easily assembled – and the prices of individual art pieces are highly unstable. Collectibles are probably volatile because buyers' tastes can change suddenly (e.g., from antique furniture to contemporary art or from Rembrandt to Warhol). In contrast, gold's unique physical attributes have allowed it to remain the preferred hedge against default, inflation and equity risk. Thus, gold's long-term valuation using the Fund's proprietary method has been stable over the last century. It seems improbable that will change. That said, gold can be volatile in the short-term – as can any asset.

More recently some have argued that rising real interest rates will make gold less attractive than interest-earning deposits. However, any downside from higher rates is highly likely to be swamped by the positive effect of gold's low valuation and rising concerns about default, inflation and equity risk.  For example, gold rose dramatically in the early 1970s and mid-2000s – the recent periods in which real interest rates rose sharply while gold was undervalued.

Just after the Great Inflation, some advisors recommended an aggressive 25% gold allocation.[14] However, after a 30+ year bond and equity boom, the typical allocation now seems closer to zero and sentiment toward gold seems awful. For example, 2015 headlines in major publications included: “Gold Is Doomed,” “Gold Is Only Going to Get Worse” and "Let's Be Honest About Gold: It's a Pet Rock." Yet hated assets are usually undervalued assets. For example, in 1978, *BusinessWeek’s* “The Death of Equities" headline nearly marked the start of an equity boom that may be ending only now.

## Portfolio

The Fund's portfolio is summarized below:

| Category | January 2016 Weight | July 2015 Weight |
|---|---|---|
| Gold-Linked Securities (GLS) | 70% | 35% |
| Countercyclical China-Related Companies (CCCs) | 20% | 48% |
| UK Company | 10% | 17% |
| Cash | 0% | 0% |
| **Total** | **100%** | **100%** |

The Fund’s 70% allocation to GLS includes a 25% allocation to a single security. The GLS, especially the single security, are perhaps the most attractive investments I have seen due to their extreme potential upside and very low probability of long-term loss. Charlie Munger said it well: “If you only put 20% into the opportunity of a lifetime, you are not being rational.”

Although the countercyclical China-related companies (CCCs) allocation has fallen, I expect the Fund to benefit dramatically if China slows further, which seems highly likely. Another example of China’s bubbles: Beijing’s aggregate land value was until recently seven times England’s although its area is an eighth of England’s and its population is less than half England’s.[15]

While the CCCs remain attractive, the GLS are far more attractive. Even if China’s economy slows while the bond bubble continues for another decade, the GLS seem likely to outperform the CCCs and most other assets.

Below is a breakdown of the Fund's 2015 returns:

| Category | Class A | Class B |
|---|---|---|
| Gold-Linked Securities (GLS) | 8% | 8% |
| Countercyclical China-Related Companies (CCCs) | 18% | 16% |
| UK Company | 1% | 1% |
| Cash | 0% | 0% |
| **2015 Return** | **27%** | **25%** |

As expected, the CCCs appreciated as China continued to slow.

## Other

As always, I have the majority of my net worth invested in the Fund.

Unlike most mutual and hedge funds, the Fund continues to strive for tax efficiency and has yet to incur any short-term capital gains. In 2H2015, the Fund used new partner contributions to adjust investment allocations without incurring taxes.

The Fund's most important competitive advantage will always be its patient clients, so I greatly appreciate your continued support.

Partners will receive several items over the next six months:

- Account statements will be sent this week and now include both gross and net returns (i.e., returns before and after the performance allocation)
- Tax documents will probably be sent by March
- The Fund's audited financial statements will be sent by May
- The Fund's next letter will be sent in July

Please contact me with any questions or comments.

Kind regards,
Brian

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# Endnotes

[1] Source: McKinsey Global Institute
[2] Source: IMF, Carmen Reinhart. As measured by the gross central government debt to GDP ratio since 1900
[3] Source: Bank of England. “Interest rates” refers to nominal interest rates unless otherwise noted
[4] Source: Deutsche Bank; *Distant Tyranny: Markets, Power, and Backwardness in Spain, 1650-1800*; *Handbook of Key Global Financial Markets, Institutions, and Infrastructure*
[5] Source: Ned Davis Research. Median market capitalization to sales data is available since 1964
[6] Credit Suisse seems to have coined the term “triple bubble” in reference to China’s economy
[7] Source: International Cement Review, US Geological Survey
[8] See Fund’s July 2015 presentation
[9] As measured by the gross central government debt to to GDP ratio or gross central government debt to tax revenue ratio
[10] CBs’ quantitative easing bond buying shortens government debt maturities by converting governments’ long-term debt obligations into short-term debt hidden on CBs’ balance sheets (i.e., interest-bearing excess reserves which are equivalent to short-term debt)
[11] The ruler metaphor seems to have originated with John Hussman
[12] This assumes that gold’s valuation would increase to at least its 1980 peak level since a global government debt crisis would probably cause worse inflation than the Great Inflation
[13] Source: *The investment performance of art and other collectibles*
[14] Source: *Fail-Safe Investing*
[15] Source: China Vanke, Wharton/NUS/Tsinghua Chinese Residential Land Price Index, Andy Wightman, Knight Frank

## Legal Disclaimer

The Hirschmann Partnership LP (the "Fund") began operating on October 1, 2014. The Fund's principal objective is to achieve positive market returns primarily through fundamental analysis of small- and micro-cap equities in U.S. and foreign markets. Hirschmann Capital LLC (the "General Partner") seeks to achieve the Fund's investment objective by identifying equities that are trading at large discounts to actual value. The Fund invests primarily in small- and micro-cap equities in U.S. and foreign markets but also invests in other securities, bonds, commodities and derivatives. An investment in the Fund should be considered a long-term investment.

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Performance results shown are for the Hirschmann Partnership LP and are presented net of all fees, including performance allocation, brokerage commissions and other operating expenses of the Fund. Net performance includes the reinvestment of all dividends, interest, and capital gains. The General Partner does not receive any asset-based management fees. For each Class A Limited Partner, the General Partner is allocated a performance allocation equal to 25% of the amount by which the increase in net asset value exceeds a 6% annualized hurdle rate. For each Class B Limited Partner, the General Partner is allocated a performance allocation equal to 33% of the amount by which the increase in net asset value exceeds the S&P 500 Index.

In practice, the performance allocation is earned annually or upon a withdrawal from the Fund. Because some investors may have different fee arrangements and depending on the timing of a specific investment, net performance for an individual investor may vary from the net performance as stated herein.

This document refers to indices such as the S&P 500 and MSCI World. Reference to an index does not imply that the Fund will have returns, volatility or other characteristics similar to the index. The indices only contain equities while the Fund may invest in other securities. The Fund is significantly more concentrated than the indices and may experience higher volatility. You cannot invest directly in the indices.

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