July 13, 2017

Dear Partner,

Updated results, net of all fees, for the Hirschmann Partnership (the "Fund") are shown below:

	Class A Return	Class B Return	S&P 500 Index	MSCI World Index	Gold
Q4 2014	-2.2%	-2.2%	4.9%	1.0%	-2.2%
2015	27.0%	24.8%	1.4%	-0.5%	-10.4%
2016	47.1%	44.7%	12.0%	7.9%	9.1%
H1 2017	6.8%	8.0%	9.3%	10.9%	7.3%
Cumulative	**95.0%**	**90.8%**	**30.2%**	**20.2%**	**2.5%**
Annualized	**27.5%**	**26.5%**	**10.1%**	**6.9%**	**0.9%**

Although the Fund underperformed its benchmarks in H1 2017, it remains highly likely to rout them over the next five years. As I've said before, temporary underperformance is the unavoidable price of long-term outperformance. Indeed Berkshire Hathaway lagged the S&P 500 by 143% during the 1995-99 dot-com bubble before rocketing past it in 2000-03.

Our present portfolio, summarized below, has changed little and remains extremely attractive:

Category	July 2017 Weight	January 2017 Weight
Gold-Linked Securities (GLS)	86%	87%
UK Company	8%	6%
Countercyclical China-Related Companies (CCCs)	5%	7%
Cash	0%	0%
Total	**100%**	**100%**

Most of the Fund's gross return (i.e. before the performance allocation) again came from the gold-linked securities (GLS):

Category	Return
Gold-Linked Securities (GLS)	5%
Countercyclical China-Related Companies (CCCs)	-1%
UK Company	3%
Cash	0%
H1 2017 Gross Return	**8%**

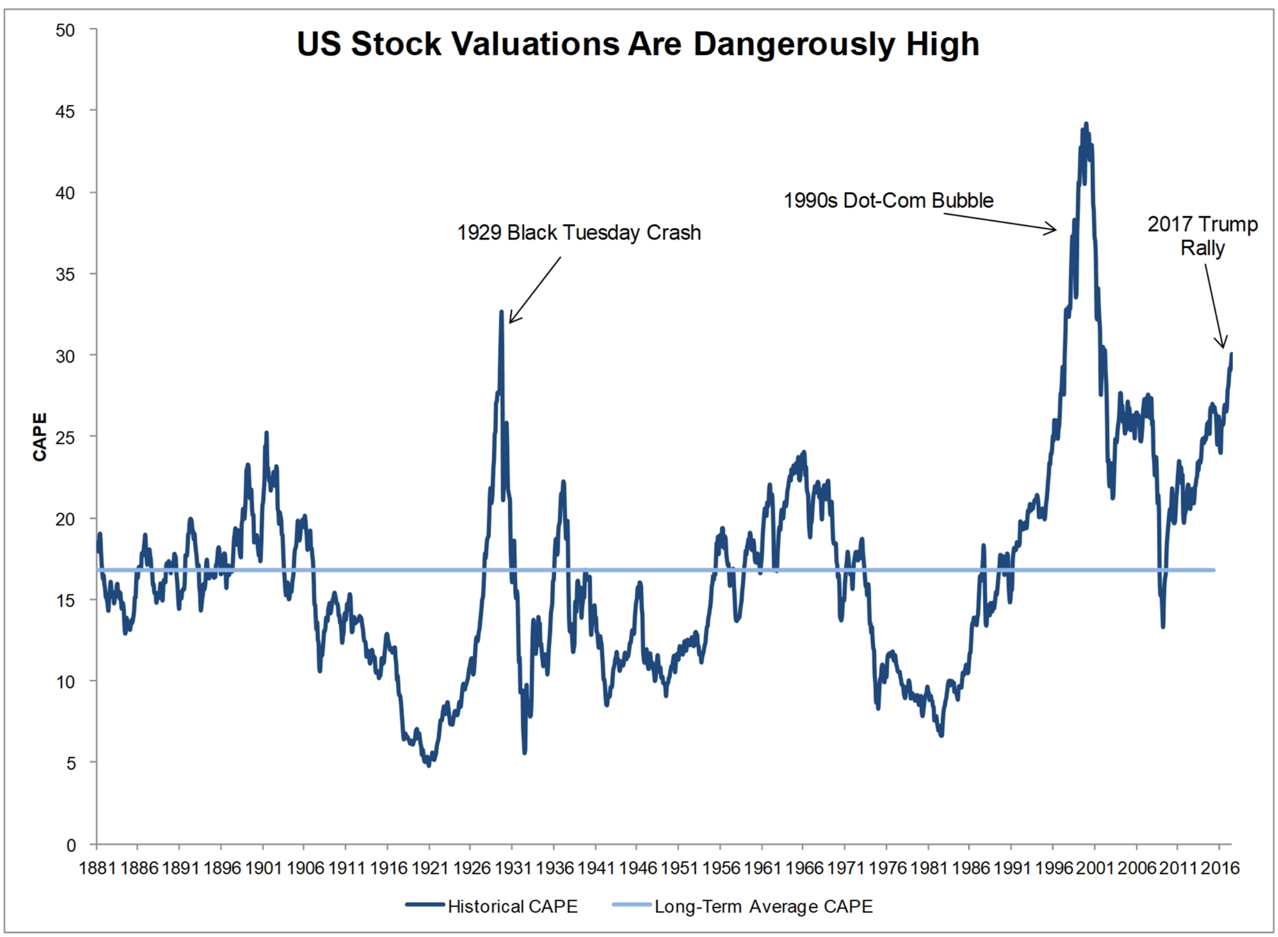
The Fund's high GLS allocation, including a 28% position in a single security, still seems justified by the GLS' very low probability of long-term loss and extreme potential upside if the bubbles in bonds, China or US equities burst.

US Equity Bubble

In the last letter, the bond bubble was in my crosshairs. This time we'll focus on the US equity bubble. Let's start with a few red flags:

- Borrowing to buy US equities is just shy of its all-time high as a percent of their value[1]
- In a sign that retail investors are piling into US equities, Charles Schwab opened new brokerage accounts in Q1 2017 at the fastest pace since the peak of the dot-com bubble
- In an example of US equities' absurd valuation relative to foreign equities, Tesla, until recently the largest US-listed auto stock, is valued ~100 times more per car sold than foreign-listed Hyundai, Nissan and Fiat Chrysler[2]
- Facebook, with only 18,000 workers, has a larger market capitalization than India, with 1.3 billion people[3]
- Amazon, the 3rd largest US stock, trades at ~200 times last year's earnings and ~80 times its cumulative earnings since 1994

To analyze the bubble, we turn to the cyclically-adjusted price earnings ratio (CAPE). CAPE is the ratio of equities' market capitalization to their average earnings for the preceding ten years. When CAPE is above its historical average, future equity returns tend to be below-average and vice versa. Currently, US equities' CAPE (US CAPE) is nearly double its historical average—higher than at any time other than the Roaring Twenties and dot-com bubbles.



US CAPE is more than double its foreign equivalent—its highest relative ratio ever. Every time a country's CAPE has risen to double its foreign equivalent, a 50-80% stock market crash has followed (e.g. the 1980s Japanese asset price bubble).[4]

Index	CAPE
Developing Markets	12.9
Developed Markets (ex. US)	13.9
US	**30.1**

Contrary to popular opinion, current low interest rates don't justify the high US CAPE. Most foreign markets (e.g. the EU, Australia and Canada) have low rates but far more modest CAPEs. In the past, the US CAPE has averaged half its current level during periods of low US rates.[5] Further, as discussed in previous letters, a global government debt crisis seems inevitable and thus continued low rates are highly unlikely.

Nor can high US CAPE be explained by expected GDP growth. Recent US growth (~1%),[6] the IMF's US growth forecast (~2%)[7] and even the Trump administration's rosy forecast (3%)[8] are below historical average growth (~3.2%).[9]

Potential corporate tax cuts don't warrant a high CAPE either. Historically, corporate tax cuts haven't increased corporate earnings. For example, corporate return on equity hasn't improved since the 1960s despite a 33% drop in corporate tax rates.[10] Generally, this is because the earnings benefit from tax cuts is short-lived: as soon as earnings rise, increased competition drives them back down.

Equally silly is the claim that the US CAPE is justified because mutual funds and exchange-traded funds (ETFs) have enabled investors to diversify cheaply (e.g. a S&P 500 ETF), thereby lowering equity risk. First, widespread use of such funds hasn't caused a comparable run-up in foreign CAPEs. Second, an S&P 500 ETF is only slightly less volatile than a diversified 30 stock portfolio, which would have been available to investors a century ago.[11]

Other

I continue to be the Fund's largest investor and to hold the majority of my net worth in the Fund. At June 30, the Fund had a ~0.20% operating expense ratio (i.e. bookkeeping, audit and other expenses divided by assets).

The Fund continues to strive for tax efficiency and has yet to incur any short-term capital gains.

Partners will receive their next letter and account statement by mid-January.

The Fund's most important competitive advantage will always be its patient clients, so I greatly appreciate your continued support. Please contact me with any questions or comments.

Kind regards,
Brian

Endnotes

[1] Source: New York Stock Exchange (NYSE). Based on NYSE member firm customer accounts since 1959. Investor borrowing equals margin debt less cash in margin accounts. Although such margin debt is primarily used for buying US equities, some of it was probably used to buy other assets. The S&P 500 is used as a proxy for US equities' value
[2] Based on 2016 car sales
[3] The MSCI India Index, which covers 85% of the Indian equity universe, is used as a proxy for India's market capitalization
[4] Source: Bank of England, Research Affiliates, Robert Shiller. Based on foreign CAPE data since 1980 and UK CAPE data since 1937. Japan CAPE has been adjusted for accounting differences. See "Valuing Japanese shares" by Andrew Smithers
[5] Source: Robert Shiller. Periods of low US rates refer to the 485 months between 1881-2008 in which the US 10 Year Treasury Note was 3.46% or less
[6] Source: Federal Reserve. Based on real GDP growth over the last decade
[7] Source: IMF. Based on projected GDP growth from 2017-22
[8] Source: MarketWatch. Based on 2021-27 projected growth in May budget. May budget projected lower growth from 2017-20
[9] Source: US Census, Maddison Project. Based on data from 1880-2010
[10] Source: Federal Reserve, Tax Policy Center
[11] For example, in the 1920s, an investor could have created a diversified portfolio by purchasing the 30 stocks in the Dow Jones Industrial Average. That would not have been expensive because an equity trade's average cost has probably fallen only ~30bps since the 1920s. See "A Century of Stock Market Liquidity and Trading Costs" by Charles Jones

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.

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