January 15, 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
Q4 2014	-2.2%	-2.2%	4.9%	1.0%
2015	27.0%	24.8%	1.4%	-0.5%
2016	47.1%	44.7%	12.0%	7.9%
Cumulative	**82.7%**	**76.6%**	**19.1%**	**8.5%**
Annualized	**30.7%**	**28.7%**	**8.1%**	**3.7%**

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.

Although the Fund outperformed its benchmarks and nearly all other funds in 2016, Classes A and B fell 14.6% and 12.4% respectively in the second half of 2016 due to the falling gold price, while the S&P 500 appreciated 7.8%. In the first two weeks of 2017, however, Classes A and B appreciated 15.4% and 14.2% respectively while the S&P 500 appreciated 1.7%.

Unfortunately temporary underperformance, such as what we experienced in the second half of 2016, is nearly always the price of long-term outperformance. Scion Capital, depicted in the *The Big Short* movie, suffered a 19% loss in 2006 betting against the housing bubble before earning 138% in 2007 as the bubble burst.

Our present portfolio, summarized below, seems as attractive as it has ever been and thus I remain very optimistic about the next five years:

Category	January 2017 Weight	July 2016 Weight
Gold-Linked Securities (GLS)	87%	86%
Countercyclical China-Related Companies (CCCs)	7%	6%
UK Company	6%	3%
Cash	0%	5%
Total	**100%**	**100%**

Most of the Fund's 2016 gross return (i.e. before the performance allocation) came from the gold-linked securities (GLS):

Category	Return
Gold-Linked Securities (GLS)	62%
Countercyclical China-Related Companies (CCCs)	3%
UK Company	-4%
Cash	0%
2016 Gross Return	**61%**

The Fund's gross returns in the first and second half of 2016 were 95% and -18% respectively, while gold's returns were 26% and -14% over the same periods. Thus, as expected, the GLS substantially outperformed gold.

I continue to expect gold to rise over the long-term because: (i) it remains below its long-term average valuation, using the Fund's proprietary method, and (ii) it tends to benefit from greater concern about default, inflation and equity risk. If gold rises, the GLS should appreciate much more. Further, if any of the bubbles in bonds, China or US stocks burst, the GLS seem likely to appreciate more than 500%. (Since the GLS seem extremely undervalued, they also seem likely to appreciate over the long-term even if gold falls substantially.)

The Fund's high GLS concentration, which includes a 28% allocation to a single security, is unconventional – just as Scion Capital's concentrated housing bubble shorts were unconventional. Nevertheless, the Fund's concentration seems more than justified by the GLS' extreme potential upside and their very low probability of long-term loss. When conventional assets (e.g. bonds, US stocks) seem very overvalued, an unconventional portfolio seems wise.

Although some foreign stock markets seem undervalued (e.g. the UK), they seem far less attractive than the GLS. Hence, over the past two years, I have reduced the Fund's UK Company allocation.

Bond Misconceptions

The bond and US stock bubbles are premised on US government (USG) interest rates remaining very low. Thus, one way those bubbles might end is if investors realize that the USG is likely to default through higher inflation. After all, 45 of 46 countries with peacetime debt/GDP ratios equal to the USG's 105% ratio have defaulted.[1]

Let me dispatch six common arguments for why the USG won't default:

#1: Politicians will implement austerity (e.g. raise taxes and reduce spending) to avoid default.

They might – but in 45 of 46 similar situations they didn't. When markets are calm, politicians are reluctant to sacrifice short-term votes to improve long-term solvency (e.g. Donald Trump's tax plan). Once interest rates spike, it is usually too late for austerity because higher borrowing costs overwhelm tax increases and spending cuts (e.g. European PIIGS). Even timely austerity often fails because it reduces growth, which increases budget deficits. (Austerity has not reduced debt/GDP ratios in France or the UK).

#2: If a crisis occurs, the Fed can end it by lowering interest rates.

Ultimately interest rates are set by markets, not central banks. A central bank cannot keep interest rates low if inflation expectations are high (e.g. Brazil, India, Turkey, South Africa and the 1965-82 US Great Inflation).

If investors concluded that the USG is likely to default through inflation, they would demand far higher interest rates. The Fed would then be trapped. If it hiked interest rates to lower inflation as it did in 1979, it would trigger an outright USG default since debt/GDP is extremely high – more than three times its 1979 level. If it attempted to lower interest rates by printing money to buy USG debt, inflation would drive rates up. Similarly, Brazil's central bank was unable to lower interest rates during Brazil's 2002-03 and 2015-16 crises.

Quantitative easing (QE) wouldn't help either. Contrary to popular belief, QE consists of the Fed buying long-term debt by issuing short-term debt, not by printing money.[2] Thus, QE is only effective if the Fed can issue low-cost short-term debt – a hopeless task during a debt crisis.

#3: The USG won't have a debt crisis because its debt is the preferred safe paper asset.

Prior to the 1965-82 US Great Inflation, USG debt was also the preferred safe paper asset. Yet that didn't prevent the crisis (USG debt yields reached 16% in 1981) and so it seems unlikely to prevent the next one.

#4: 20% of USG debt doesn't count because it's held by the Social Security (SS) trust fund.

This is silly because that debt has to be paid unless SS is ended – a politically unacceptable option. Even after suffering severe debt crises, the European PIIGs never considered ending their versions of SS. Further, even if SS were ended, the USG's debt/GDP ratio would probably remain at levels that have resulted in default more than 90% of the time.[3]

#5: The USG paid its large World War II (WWII) debt, so it can pay its current debt.

In reality, the USG reduced its WWII debt primarily by defaulting through high inflation (e.g. 1946-48 inflation totaled 34%), so that's hardly an argument for why the USG won't default again. Further, demobilization resulted in large budget surpluses (e.g. 3% in 1948), which aided debt reduction and calmed the bond market. In contrast, the USG is currently running large budget deficits (e.g. 3% in 2016), which are projected to increase debt/GDP ratios even under the USG's own rosy projections.

#6: Japan and Italy have avoided default despite higher government debt levels than the USG.

Japan also seems in the midst of a bond bubble that will inevitably lead to default. For example, if the interest rate on Japanese government debt increases 500bps, interest expense alone will exceed government revenue. Italy has avoided default thus far only through support from less indebted eurozone members (e.g. Germany).[4] Even so, Italian default seems unavoidable since Italians are tiring of austerity and Italy's debt levels are not improving. Finally, many developed countries, including the US itself, have defaulted at much lower debt levels than the US currently has (e.g. US 1933, UK 1976, Portugal 1983 and Spain 2012).[5]

Since most developed world governments (e.g. Japan, the US and much of Europe) seem near default, a global debt crisis with surging inflation and interest rates seems likely. Such a crisis would probably cause a massive stock market crash and otherwise wreck global financial markets. The US stock market would fall ~75% if its cyclically adjusted price-to-earnings ratio returned to its low during the 1965-82 Great Inflation. Corporate defaults would probably also surge. S&P 500 companies currently have their highest debt to profit ratio ever.[6] Rising inflation, plunging markets and soaring defaults would almost certainly increase gold's appeal as one of the rare assets immune to those risks.

China

China's rapid growth since 2008 seems due to a massive debt-funded construction and real estate bubble. China is consuming 60% of global cement – five times more cement per capita than the rest of the world – and is issuing $7 of debt per dollar of GDP growth. (By comparison the US was issuing just $3 of debt per dollar of GDP growth during its housing bubble.) [7] [8]

Every past debt bubble has ended: Japan's Lost 20 Years, Asia's 1997 financial crisis, Spain's ongoing crisis, and so forth. China's probably will also and if it does, Chinese GDP growth might, based on prior booms, fall from 7% to less than zero.[9] Since China represents ~40% of 2017 expected global GDP growth, such a slowdown would probably cripple global growth.

Although the Fund's countercyclical China-related companies (CCCs) allocation is small, I continue to expect the Fund to benefit tremendously if China slows further. Unfortunately, I cannot explain why that is without compromising the Fund.

Other

In the second half, the Fund fully exited investments for the second and third time. Those investments had more than doubled in the year that we held them. Confidentiality remains critical since the investments are similar to an existing one.

I continue to be the Fund's largest investor and to hold the majority of my net worth in the Fund.

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

In December, the Fund's office moved to Santa Monica. Please remember my overhead (e.g. rent, salary and research costs) are not charged to the Fund.

Partners will receive several items over the next six months:

- Account statements will be sent this week
- Tax documents will probably be sent by March
- As part of the Fund's 2016 audit, the Fund's auditor will contact certain partners to confirm their transactions since August

- The Fund’s audited financial statements will be sent by May
- The Fund’s next letter will be sent in mid-July

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] See July 2015 Presentation
[2] Interest-bearing excess reserves held by banks at the Fed are equivalent to short-term debt issued by the USG
[3] Source: Carmen Reinhart. Default rate is based on sixty episodes of 75% or higher peacetime debt/GDP ratios. High wartime debt episodes are excluded because demobilization can result in large budget surpluses (e.g. US and UK after World War II)
[4] For example, through the TARGET2 system, Germany has financed huge purchases of Italian government bonds by the European Central Bank
[5] In 1933 the US defaulted by leaving the gold standard. The UK (1976), Portugal (1983) and Spain (2012) effectively defaulted because they were bailed out to avert default
[6] Source: Barclays. Based on debt to EBITDA since 2000 for the S&P 500 (excluding financial companies)
[7] Source: Holowesko Partners
[8] Source: Morgan Stanley
[9] See July 2015 Presentation

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.

The information contained herein reflects the opinions and projections of the General Partner on the publication date. The opinions and projections are subject to change without notice at any time. The General Partner does not represent that any opinion or projection will be realized. All information provided is for information only and is not investment advice or a recommendation to purchase or sell any specific security. The General Partner has an economic interest in the securities discussed in this document, but the General Partner’s economic interest is subject to change without notice. While the information presented herein is believed to be reliable, no representation or warranty is made concerning the accuracy of any data presented.

Securities discussed in this document may not remain in the Fund’s portfolio when you receive the document and securities sold may have been repurchased. The securities discussed may not represent the Fund’s entire portfolio. Do not assume any of the securities discussed were or will be profitable. Do not assume that future investment decisions will be profitable or will equal the investment performance of the securities discussed. Past results are no guarantee of future results. No representation is made that an investor is likely to achieve results similar to those shown. All investments involve risk including the loss of principal.

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.

This document is confidential and may not be distributed without the consent of the General Partner. This document does not constitute an offer or solicitation to purchase or sell any security or investment product. Any such offer or solicitation may only be made by means of an approved Confidential Offering Memorandum.