Focused COMPOUNDING

July 1st, 2018

Dear Investment Partner:

Andrew here. Welcome to Focused Compounding Capital Management. As everyone knows, Geoff and I decided we would send monthly memos to keep the lines of communication constant so everyone would be kept well-informed. You should expect to receive our monthly memo on the 1st of every month going forward. Our goal in our communications with you is to give you the information we would want to know if our positions were reversed. Before Geoff dives into discussing the portfolio ***next*** month, I thought I'd spend ***this*** month briefly going over our **3-tenet checklist** that Geoff and I think a lot about before adding a new position to the portfolio.

Tenet 1: We need an edge - The stock needs to have (what we believe) is a positive expected value of outperforming the market in addition to our management fee over the next 5-10 years. For example, if Geoff and I think the market over the next 10 years will perform in the area of 5-7%, we will only invest in a stock if we believe the business has the ability to compound at a rate that is higher than 7.5-9.5% per year (market performance plus our 2.5% management fee) over the next 10 years. Of course, sometimes the IRR in stocks can happen a lot faster than 10 years, and this is when you will see us realize gains and redeploy the capital into other stocks.

Tenet 2: The stock needs to have a "High Geometric Mean" - Everyone wants the highest CAGR, obviously, but we think we take it a step further by thinking about achieving the highest annual return combined with the lowest chance of a stock ever being a zero in any given year. Again, every investment manager always says this, but then if you take a look at some of the stocks in their portfolio their positions don't always reflect that line of thinking. A stock with a 20% return in most years that has a 10% chance of going to zero each year is a bad stock to own in our eyes. But, so is a zero-coupon bond with a guaranteed return of 4% a year and no chance of ever being a zero. A Buffett stock is usually a high CAGR stock that is likely to grow 8% a year in the worst case and 16% in a good case with an almost 0% chance of going to zero in any one year. Those are the companies that we are looking to build a portfolio around. I wish I could take credit for this, but Geoff has really helped me develop this filter and decided it's a crucial tenet of every stock that we will own.

Tenet 3: We need to actually be able to buy it - Given that one category in our overlooked stocks group is illiquid stocks, we need to make sure that we can actually buy the shares in the open market with no issues. Almost every investor who has joined Focused Compounding Capital Management has asked us: "What if your assets under management grow too large to the point of not being able to invest in illiquid stocks anymore?" Geoff and I don't aspire to manage billions. We are more concerned with performing well for our partners and staying lean with our overhead to allow us to keep our concentrated investor base happy. We don't foresee running into issues with illiquid stocks till we have many more millions of assets under management.

Next month, Geoff will write to you about the six stocks that make up your initial portfolio.

Sincerely,
Andrew Kuhn (info@focusedcompounding.com)