VILASCAPITAL
MANAGEMENT LLC

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Dear Partner,

The Vilas Fund, LP (the Fund) rose 3.34% in the first quarter of 2017, which compares to the 6.07% return of the S&P 500 Index, including reinvested dividends. The following is a comparison of the Fund vs the S&P 500 and the HFRI Fundamental Value Index over longer time periods:

As of 03/31/2017	The Vilas Fund NAV	S&P 500 (SPXTR)	HFR Fundamental Value Index (HFRIEHFV)*
1 Year	87.43%	17.17%	12.75%
3 Year	-1.06%	10.37%	3.23%
5 Year	12.89%	13.30%	6.38%
Since Inception *	14.70%	14.19%	6.38%
			* August 9, 2010

Since the Fund began operations on 8/9/2010, it has compounded $1 into $2.49 vs $2.41 for the S&P 500 Index and $1.51 for the HFR Fundamental Value Index. Importantly, this was accomplished over the last six and a half years when “deep value” stocks have dramatically underperformed “glamour” stocks. Thus, the Fund has stayed slightly ahead of the market and considerably ahead of the average fund despite the fact that our strategy has been “swimming upstream” for nearly 7 years.

For our taxable partners, the Fund has distributed a net negative amount of capital gains since the inception of the Fund. Thus, the after-tax returns of the Fund are slightly higher than those posted due to our focus on tax efficiency. A good portion of our competition are very active traders and the returns they generate create significant quantities of short term capital gains or interest income. Thus, in highly taxed States, the after-tax return of the competition would be only roughly 50-60% of the advertised returns. While we don't foresee being able to defer taxes forever, we do attempt to minimize taxes if at all possible.

Investment Strategy

As we have communicated in the past, the Fund uses a value strategy and attempts to arbitrage the forward return differential between the cheapest and most expensive equities. A variety of academic and industry papers have shown the differential, between the first and tenth decile of stocks, to be 9.5% per year over rolling 5 year periods of time. Thus, a basket of the cheapest equities should outperform a basket of the most expensive equities by nearly 10% per year. Our Fund, in a nutshell, owns companies within the cheapest decile and, with a far smaller amount of capital, shorts a handful of companies in the most expensive decile. As this phenomenon works nearly identically worldwide, we look for companies both inside the US and in developed locations, such as the UK, Switzerland and Germany.

The main explanation for this phenomenon is that investors, in aggregate, tend get overly excited about certain equities, "equating a good investment with a well-run company irrespective of price." * Further, they tend to extrapolate past rapid growth rates too far into the future, causing valuations to become extremely expensive. It is the "irrespective of price" part that is the Achilles' Heel of those who invest in this manner. We have seen this phenomenon repeat with a variety of assets, from the first round of "new economy" technology and internet stocks in the late 1990's, commodity stocks in the mid-2000's due to the "we are running out of oil, copper, etc" theory, condos and houses in the mid-2000's because of a "shortage of buildable lots", etc. Over time, the investment community is drawn to these "glamour" investments that seem to captivate their imaginations and tend to ignore steady, boring investments with consistent profits, reasonable valuations, and modest growth rates. This creates the long-term opportunity.

We are careful to make sure that the equities we buy are not cheap for good reasons, including businesses in permanent decline or those on the verge of bankruptcy. Similarly, we strive to sell short companies that are both extremely expensive and who have long term structural issues that could prevent them from earning good returns on shareholder equity. Ideally, these expensive companies would eventually run into financial trouble due to poor balance sheets and credit ratings.

The strategy, outlined above, tends to work very well over rolling 5 year periods. Not all periods, however. The 5 years leading up to 2000 would have been very difficult as the market became unhinged from logic or realistic outcome analysis and a massive bubble appeared. In these time frames, the Fund will struggle. Over the last decade, "glamour" styles have crushed value strategies, though not to the extreme we witnessed in the late 1990's. Using the S&P Value and Growth Indices, which split the market into two halves instead of deciles, the value index has underperformed the growth index by 2.87% per year over the last 10 years. The differential between the cheapest decile and most expensive did far worse than this due to the severe underperformance of financial, auto and energy stocks relative to the high flyers in the technology space. Thus, though the long-term data of value outperformance is compelling, we appear to be nearing an inflection point where past performance, and therefore valuations, have diverged excessively.

Glamour stocks, or those defined as possessing extremely high valuations, shares that have risen parabolically, and rapid recent sales growth, in many cases are selling at multiples of earnings (if profitable) and tangible book value that are 10-20 times their more pedestrian competitors. At the same time, the shares of the cheapest decile companies are selling at absurdly low valuations. In most cases, these inexpensive shares appear to be predicting a dire economic reality, including a deep recession with horrendously low levels of auto sales. This leads to a very strange situation. If the economy is decent, these value shares should shine and experience significant valuation expansion while the glamour stocks should see multiples contract due to their "growth exclusivity" declining. If the economy does, in fact, experience a material recession, the value stocks are, more or less, priced for it while the glamour stocks, based on history, would crash.

As with chewing gum, bubbles in markets inflate slowly and deflate very rapidly. This is why they describe situations like 1999 "bubbles". Some parts of the stock market are currently in a bubble. Social media, internet retail, cloud computing, electronic distribution of movies, and green energy companies all appear to be in a bubble of one size or another. As an anecdotal example, within a week and a half I was on two chairlifts with random people who asked me what I did for a living. Their next comment was "how do you like Tesla?". They each owned shares. One was a retired Bank of America software engineer and one was an electrical engineer at a company in Boulder, CO. I briefly explained why I thought that the stock wouldn't perform well from here. They said, to paraphrase, “but batteries and electric cars are the future” and that “Elon Musk is brilliant”. Then, a few days later at a dinner party, I sat next to a materials engineer who worked at a defense contractor in Boulder who, after hearing I was in the investment business, trotted out that he liked the whole “solar, battery and car ecosystem Tesla was building” and that “Tesla would have to be a great stock for the next decade”.

While not waiters, cab drivers or shoe shine boys, these people, while smart and capable in their respective fields, have no financial experience or basis for determining if the company was adequately financed or if the stock of Tesla was reasonably priced given the capital requirements, barriers to entry, or risks. Thus, it appears to us that we have entered into a bubble of sorts where people have lost their fear of loss and now only have the fear of missing out (FOMO). These folks know little of balance sheets, debt markets, cash flow, credit ratings, competitive strategy, accounting standards, capital requirements, etc. For them, the future is bright and they want a piece of it.

In another period of time in distant American history, there was another great, new technology that captivated people similarly. Prior to this technology, people had to travel to hear music, speeches or the news. Or, more commonly, they had to wait for the newspaper to be delivered the next morning. This technology allowed for music, stories and news to be played in the home: Radio. The stocks that were associated in any way with radio equipment or transmission became so hot that they made little economic sense. How did these stocks do? For a while, incredibly well. All at once, however, they crashed and crashed hard. As we all know, radio changed the world and went on to be a big business. Thus, investors were right to be excited. However, they were very wrong to pay such a high price for those stocks.

Today, we have a similar situation within the sectors we highlighted above. In most cases, these companies will thrive over longer periods of time. However, collectively, they cannot live up to the valuations ascribed to them by the markets. If we take each company we are short and look at it on a weighted average basis, it would have a market cap of $111 billion and trailing earnings of $374 million, resulting in a trailing P/E ratio of 298 times earnings. Due to this valuation extreme, we are short a number of companies in these industries.

On the other hand, the market continues to trade as if a recession is brewing. The market may be right to worry. The US is roughly 8 years into this economic expansion, which began in June of 2009. The longest expansion in US history was exactly 10 years, from 1991-2001. We do not know how long this expansion will continue but are becoming convinced that the markets are beginning to forecast a recession in the next few years. Even though the Great Recession didn't start until late 2008, the equity markets started to forecast the recession at least 18 months before the economy turned down. Based upon the extremely inexpensive trading levels of the auto and financial sectors, the declining yields of 10 and 30 year Treasuries, and the insane prices of glamour stocks, which tend to rise late in expansions due to the “growth scarcity” theory, the market seems to be preparing for an economic slowdown. We do not know what the economy will do but are positioning to profit regardless of the outcome.

The following charts illustrate some of the inexpensive multiples in the market today:

As you can see above, Honda is selling below its price-to-book ratio of 2008, as if the worldwide economy will experience a downdraft similar to the Great Recession. Barclays is selling near its 30-year low price-to-book multiple. And both Citigroup and HSBC are trading at less than <u>one-fourth</u> of their peak multiples. If a recession were to occur, it is our assertion that these stocks are nearly priced for that outcome and that they would hold up well, both absolutely and relatively. Lending standards have been very tight, worldwide, and auto sales, while cyclical, are unlikely to fall below 13-14 million units per year in the US, which is far better than the 10 million bottom in 2009. On the other hand, these are great companies. Incredibly profitable. Investing for the future. As time goes on, they will be larger and larger and will grow their earnings because they have strong franchises. Eventually, these companies should see increases in their valuations back to prior averages, which would lead to significant outperformance.

Due to the strategy of the Fund, we have suffered, over the last six and a half years, from the expansion of the second "New Economy" bubble and the disillusionment with the "Old Economy" stocks. However, if a period such as the bubble popping in 2000-2001 were to occur, we believe that our Fund is nearly perfectly positioned to provide improved returns. On a weighted average basis, our short positions are trading at valuation levels roughly 5 times higher than where a rigorous probabilistic scenario would ascribe. Further, our long positions should eventually trade at valuation multiples that are 50-100% higher than where they are today. Due to this, and despite certain volatility, the Fund should experience a satisfactory risk adjusted outcome over the next few years.

Sincerely,

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***** *Contrariam Investment, Extrapolation and Risk, Lakonishok, Shleifer and Vishny, 1994*

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