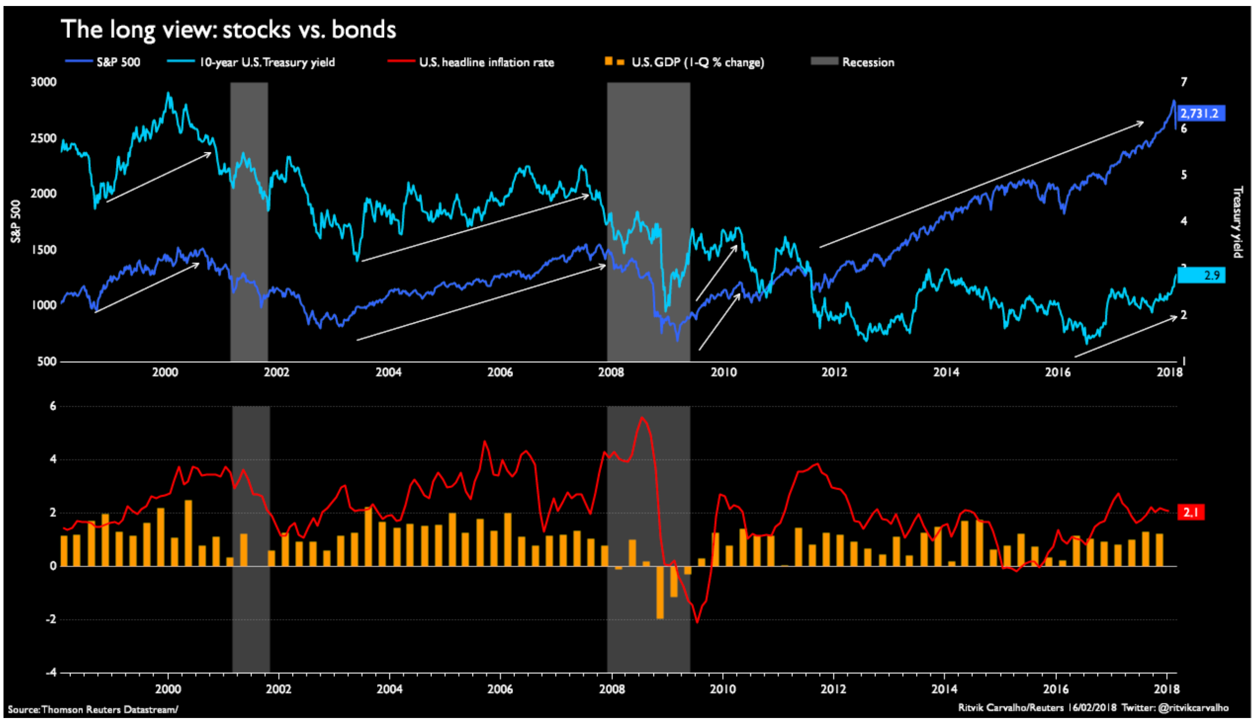
Luxembourg, February 28th, 2018

Dear Limited Partners,

Investors are currently overwhelmed with information about Central Banks regarding future interest rate increases and/or lowering QE programs.

I did not write this memo to discuss future central bank policies, but first to analyze the effects of an interest rate increase on stock prices (this might also be true for some real estate markets). Secondly, to present you a cheap insurance against market turmoil due to such an interest rate increase.

Higher interest has a negative effect on profits of most companies. Furthermore, higher interest reduces consumption and investment of individuals. Finally, a higher risk-free rate implies that investors ask for a higher yield in risky assets such as bonds, stocks and real estate.



As you can see on the following chart, stock markets and treasury yields tend to increase simultaneously and vice-versa. This reflects the fact that central banks tend to increase interest in a growing economy to avoid an overheating. On the other side, they decrease interest in a recession to make investments more attractive. The economy is strong enough to absorb the higher interest.

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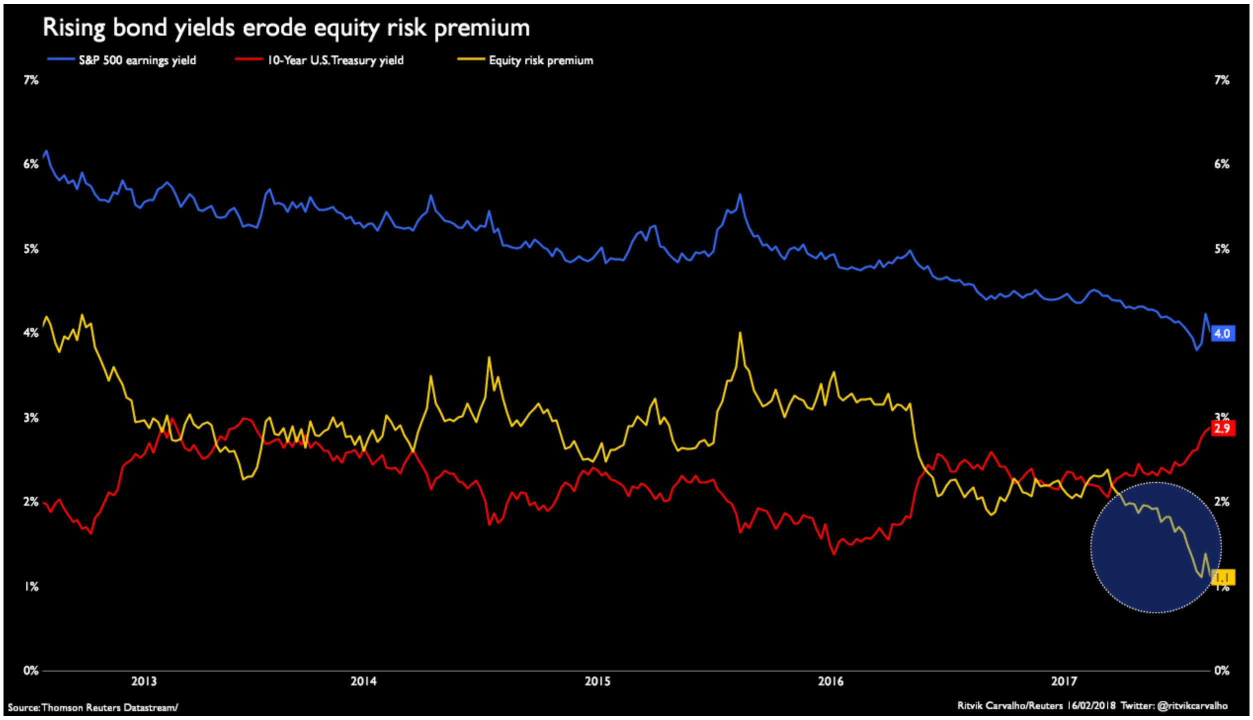

This chart compares dividend yield to treasuries. What you can see is the narrowing of these two yields and therefore, the reduction of the equity premium. The equity premium on this chart does not consider the past capital gains of the S&P500.

Stocks are, by definition, riskier than debt because in the case of a bankruptcy, creditors get paid before shareholders. Furthermore, the bondholder has no volatility risk if he holds the bond to the end. The higher risk of holding shares is compensated by the ability to participate in the appreciation of the value of the company and by a potential increase in dividend.

Over more than a century, stocks' returns have been considerably higher than T-bills' returns. The real (as to say inflation adjusted) equity return (dividend and capital gains) of stocks has been around 7.90% over the last 110 years. In that same period, the real return on a relatively risk-free security has been about 1%.

Why has the rate of return on stocks been significantly higher than the rate of return on relatively risk-free assets? By using a standard theory to estimate risk-adjusted returns, stocks should, on average, return at most a 1% premium over T-bills. This 'Equity Premium Puzzle' was discovered by Mister Mehra and Mister Prescott.

Since this puzzle was first determined in 1985 ("The Equity Premium: A Puzzle" by Mehra and Prescott) many attempts have been made to solve the puzzle. However, none of the underlying explanations are convincing because they need to present a plausible explanation of why the future is likely to be any different from the past.

The total return of stocks is the sum of dividend yield and capital gains. The higher return on stocks in the past is mainly due to the capital gains. Nowadays, as you can notice in the second chart, dividend yield and risk-free interest yield tend to narrow, or even go to 0. Today, this means that the choice of being a shareholder or creditor depends even more on the future capital gains/losses and on increases/reductions in dividends.

As we noticed before, equity tends to outperform debt over the long run. However, the investment horizon of most investors is not 100 years but let us consider it for this case to be about 5 years.

Let us take the example of the company Harley Davidson ("HOG"). I chose HOG because it is a famous brand that sells a simple product and it is easy to understand its distribution channels. One does not need much time to understand the concept of the company. The criteria for my searches were:

- low or no past revenue growth;
- increase in EBIT;
- no revenue growth projection;
- high dividend yield;
- high pay out ratio;
- increase in debt;
- large share repurchase program;

Currently the 5-year bond yields around 3.5% and trades just under Par. The dividend yield is 3.13%.

In this case, over a five-year period, the interest is higher than the dividend yield. Investors of stocks seem to either believe in an increase of the dividend or in a capital gain. To compare a 5-year bond to an equity investment, investors are not interested in the 100-year-old average return, but in the dividend and share price increase over the next five years.

If we assume that this time is no different, just as in Mrs. Reinhart and Mr. Rogoff's book, "This Time is Different", economies continue to grow in cycles and stock markets follow these booms and bust cycles; the expected future return of a stock over the next 5 years should be lower after a 9-year economic growth than during a recession

A second important point regarding the current market situation is that low interest over the last years has pushed many investors towards assets that offer a constant cash flow, such as high dividend stocks or real estate. The longer the interests were very low, the more the focus went away from the investment and onto the yield. This huge demand for dividend paying stocks increased the value of those companies and reduced the dividend yield. The result is that companies with no revenue growth and low future potential of revenue growth are trading at high valuations mainly because of their dividend.

For these types of companies, on a sector level and general economic level, the future equity premium does not seem as bright as it was in the past.

The longer an economic growth cycle lasts, the more important the nature of interest payments get. Bonds provide Cash Flow no matter what the market environment. Dividends might be cut, and the probability of a capital loss is higher during difficult times. The marginal utility of the same Cash Flow is higher during difficult times than during good times, whereas wages and profits on other assets are soaring. This is an important advantage of debt compared to equity.

As we can see, the future performance of the economy, sector and company has a high influence on the investment choice.

Are rates continuing to increase? A small increase can have huge effects, especially in the context of lower expected future equity premiums. This is the case for companies such as Harley Davidson (S&P500 “HOG”).

Hereafter I am going to analyze the case of HOG in Detail

- Current Valuation of HOG

The Net Present Value is around current market price if we consider a 1.5% yearly EPS growth.

EV/SALES is under 3, P/E is around 3 and dividend yield is 3.1% with a 47% payout ratio.

I think the company is priced for stable conditions, regarding sales and rentability.

During the last five years, HOG did not manage to generate a revenue growth in a good general economic environment. This is not because it lost market shares, but because of a declining motorcycle sector. In 2017, revenues were ($5.65 Billion) $250 Million lower than they were in 2013.

The stock price already suffered relatively to the market because of these declines in Revenue. I took my initial position at $49 per share; the same price the company traded at five years ago. The S&P500 returned close to 100% over this 5-year period. HOG was a cheap insurance in the past even if it didn’t need to pay out.

It is very difficult to predict the underlying business in the future, and even more the reaction of the stock price of the company.

One main reason for an Insurance short is that the shares do not outperform a bull market. This might be based on an underperformance of the underlying business, as to say the sale of Motorcycles.

Reasons I believe that revenues of HOG will underperform in the next five years, in any economic environment:

- HOG has and will have difficulties to find buyers of its bikes in its mature market (United States represent around 60% of its revenue). The reason for this is because its clients are on average above 40 years old and already own a Harley Davidson. As we can deduct from the disappointing revenues of HOG, it seems they have problems convincing young people to buy expensive motorcycles nowadays. This may be because of the current trend of electric cars and maybe bikes.
- Project Livewire, which is the result of the before mentioned point. HOG says that more than 17,000 people tested the prototype of an electrical bike and gave a positive review. First off, I believe that this sample is much too small for the population and that it is biased because people tend to overreact to new products and maybe more open-minded clients tested it. Investments will be huge; pressure is high to avoid a deterioration of the brand because of a low-quality product. Furthermore, we do not know the margins yet, and there might be cannibalism effect. The release date is scheduled to be in a maximum of 18 months from February 2018.

- Many competitors are more diversified than HOG and may compete in all segments of the motorcycle market, other powersport markets and/or the automotive market. Currently, certain competitors seem to increase their investments in products that compete with HOG motorcycles.
- Pressure on Prices, a result of the before written argument. The competition is mostly much larger companies who are also selling other goods and can therefore average-down fixed costs.
- Used motorcycle prices are still low, even if they seem to stabilize. I think that used motorcycle prices for HOG have a higher correlation with new sales than for other brands or products. There are not as many technological reasons to push somebody to buy a new motorcycle as there are for a new car with lower gasoline consumption.
- Closing a production in the States to move it to Thailand. This shows that the company is reacting to the increased competition and cost pressure. But does it harm the brand? I believe so, especially in the current political situation.

Of course, the management team of HOG knows all these problems, many of which are described in the 2017 10K report. HOG can release different models at different prices to try to target new clients or they can release new models with improvements so that existing customers are pushed to buy a new bike. The new 2018 Softail has positive reviews that increase the Sales Channels, meaning the dealerships hopes to increase demand by increasing the offer.

What I conclude from revenues is that the probability is high that HOG sales will not grow faster than the economy and that during a recession, pressure on used bikes will probably increase and influence new motorcycles sales.

- What about the company's profitability?

HOG, as a motorcycle manufacturer, has a high percentage of fixed costs. This makes it even more difficult to keep the profitability of the company stable in the case of declining revenues. Furthermore, the risk of an increase in inventories is higher. As we can draw from the balance sheet, Inventory of Raw Materials and Finished Goods increased by 7%.

Operating income is down to 15.78% from more than 20% in 2014. Net income in 2017 is under 10%, which results in a drop of more than 300 basis compared to 2014. Here, again, the company is reacting to the situation by relocating part of the production outside the US.

However, until now, the shareholders did not suffer that much because the company reduced the number of outstanding shares. Earnings per share are $3.03 in 2017 and the dividend is $1.46, with retention of just under 50%.

I do not have the knowledge to estimate how much the relocating of parts of the production influences the profitability of the company. I believe that this is not that important in this case, given that I consider that the stock price will not outperform in case of an increasing profitability.

- What about Cash Flow?

Operating Cash Flow is $1 Billion (around 2.30% higher than it was in 2013), but more than 10% lower than in 2016, 2015 and 2014. Capex is $206 Million (at the same level as it was in 2013), and around 20% lower than in 2016 and 2015.

Cash Flow Financing Activities are negative $540 Million. New debt issuance finances the negative cash flow of $700 Million, which paid for dividends and stock repurchases. During the last five years, the company bought back $3.5 Billion of shares and increased debt by $1.9 Billion. The current market cap of the company is $7.9 Billion, total equity amounts to $1.84 Billion and Debt is $6.9 Billion.

The lower operational cash flows are mainly the result of a lower revenue. Capex is stable over the last five years. The company forecasts around 10% of Capex increase this year. This is partly due to the project livewire and investments to increase long-term productivity.

- Share repurchase program

I believe that the share repurchase program over the last years was not a wise decision for a company experiencing declining revenues, a sinister outlook and margin problems. The short-term benefit does not pay for the long-term debt.

Concretely, in 2015, HOG issued $750 Million of Debt to finance a share repurchase program. The company Board of Directors authorized the company to repurchase 20 Million of shares with no USD limit or time limit. In February 2018, the board authorized another 15 Million of shares to be repurchased. In 2017, the company repurchased $1.98 Million shares at an average price of $49. This is about $100 Million worth of stock market capitalization. The total amount is $3.5 Billion, as mentioned before.

Of course, share repurchase programs:

1. Increase earnings per share
2. Increase dividend yield
3. Might increase capital gains, or limit losses by creating an artificial demand for the stock

Total debt increased from $5.25 Billion in 2013 to $6.98 Billion in 2017. Total equity decreased from $3 Billion to $1.8 Billion, respectively. Assets only increased from $9.39 Billion to $9.97 Billion.

The result is a much higher indebted company, relatively to equity and assets.

I believe that HOG is not able to pay back the debts issued in the context of the share repurchase program while also keeping the dividend over a longer period (more than 10 years). This is given current Cash Flow, dividend distribution policy and the fact that the company forecasts an increase in CAPEX.

Once the share repurchase program finishes, only points 1 and 2 will persist. The third one might even have negative effects because the company was a onetime buyer. Also, logically, in times where debt is more expensive than capital, the company might dilute the shares. This might be a normal cycle for stable businesses but changing capital structure as much as HOG did in these uncertain circumstances is risky.

In a negative market environment, a higher indebted company has a higher probability of default. The consequence is that creditors ask higher interest and rating agencies may attribute lower ratings. The higher bond yield is in direct competition with the dividend yield. This, especially, is if expected future capital gains during the term of a bond seems to be limited.

Currently the 5-year bond yields around 3.5% and trades just under Par. The dividend yield is currently 3.13%.

How would an interest increase affect this situation?

A 1.5% interest increase on a 5-year bond is a plausible scenario even in a worsening economic environment. The more indebted the company is, the more developed this effect might be during a recession.

To increase dividend yield by 1.5% to match the 5% interest bond (in the case of HOG), the stock price needs to decline by 30%, with the dividend staying constant. This is a large effect on a stock price for such a small increase in interest. This is mainly because stocks were priced relatively to low interest and interest change effects count relatively, not absolutely. As a result, an interest increase from 3% to 4% does not have the same effects as an increase from 1% to 2% on the relative valuation of stock price.

On the other hand, HOG might increase its dividend from $1.46 per share to $2.30 per share to yield 5%. This means a dividend increase of more than 50%.

The risks of rising interest for indebted companies with no growth in a negative economical environment, or at least a stable one with a negative outlook, are high.

HOG has 55 different bonds outstanding, many are maturating in the short and midterm. An $877 Million bond matures in 2018. This is probably the last of higher coupon bonds that the company can refinance with a lower coupon.

- If I believe that the stock is worth less, why is it trading at $46?

Every day, millions of shares change hands around the current market price. Many buyers probably have more knowledge about the industry than I do. I read many bullish analyses and most reduce their analyses to the balance sheet or to the company itself. They do not take into consideration higher interest (with or without recession), the worsening sector conditions or increasing competition. Finally, I do not consider that the stock of HOG declines in rising markets; I just want it to underperform the three before mentioned market conditions.

Furthermore, it is a fact that humans prefer the default situation. This meaning, owning and not selling, especially if they sit on losses that are not that high so the “now or never” effect plays. It is a slow-moving process and there is less suffering, especially if you get a quarterly dividend.

Another risk is a merger take-over, which I think is a probable outcome. I think this is probable because the main problem, being a declining industry, is difficult to avoid. Of course, synergies might reduce costs, but I believe that the problem outweighs the benefits. However, I try to protect myself by selling out of the money calls, above a potential takeover target price, that become worthless if the company is taken over at a lower-than strike price. Furthermore, I try to hedge the position by long calls financed by out of the money puts. I do this because I do not think the stock price will tumble and because of the volatility smirk.

It is also worth mentioning that HOG forecasts a decrease of 10% of its tax rate, which reduces the tax burden by about $120 Million, keeping everything else stable. However, I do not think that this affects the market price because it does not change the scenario.

- What about the risk / return ratio?

First, low potential growth in revenues, in all market conditions, seems to cap the stock price. Risk to get wiped out seems low.

Furthermore, in case of increasing interest, in a positive or negative economic environment, the stock will probably underperform the market because it offers low to no growth, no pricing power and lots of debt. Finally, the reason to buy or hold the stock, based on dividend yield, weakens as interest increases and debt becomes relatively more attractive.

That is why I believe this kind of trade might be cheap insurance, with adequately high and sure payoffs.

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