KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2017 Investor Letter

Portfolio Comments

Our portfolio had a good quarter with precious metals, defense, biotech and technology stocks leading the way upward, while consumer staples stocks lagged. Our mortgage REITs prospered even while long-term interest rates varied in a wide range. Our short yen/long dollar position was hurt as the US dollar continued its fall through August, although it recovered some value in September as the dollar reversed. We were happy with the quarterly performance, as most of our themes continued to play out. However, September proved to be a month where some of the strategies corrected. So far, the fourth quarter has started out strongly, with our investment themes continuing to perform, albeit at slower rates than in the third quarter.

Third Quarter Market Conditions

July was characterized by a weak US dollar; the dollar fell most of the month with a rising euro the main reason (the euro is the largest component of the US Dollar index, the most common measure of the strength of the dollar). Emerging market stocks and commodities were the main beneficiaries. Crude oil was the big winner, bouncing back from its June swoon with West Texas Intermediate (WTI) gaining 9% during July (Brent gained almost 8%). Emerging markets, as represented by the MSCI Emerging Markets index, gained 6%, led by Hong Kong and India. The Standard & Poor's 500 index gained +2.06% (total return), led by the Telecom (bouncing back from a poor second quarter) and Technology stocks. All the S&P 500 sectors were up, but the laggards were the Industrial, Consumer Staples and Healthcare stocks. German stocks (-2.0%) and other European stocks were the only major losers for the month. Bonds were mostly unchanged for the month, although most were slightly higher, with the 10-year Treasury closing at 2.292%. Metals were all higher, led by copper (+7%), gold (+3%) and silver (+2%) while gold stocks were up 6%.

In August, stock market indices continued their upward moves as the dollar continued to weaken. The S&P 500 rose fractionally (+0.31% with dividends reinvested), although a number of sectors were down for the month. Leading sectors were Technology and Utilities; sectors that lost for the month included Energy, Telecom, Financials and Consumer Discretionary. Biotech companies were strong during the month after industry giant Gilead bought Car-T pioneer Kite Pharma. The Nasdaq outperformed other indices in August, finishing the month at a record high. Hurricane Harvey caused weakness in crude prices (closing at $46/bbl) which weighed on most energy company shares. Other commodities were strong during the month, with copper reaching a three-year high and gold reaching

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a multi-month high at $1,322/oz. Treasuries rallied during the month, closing at a 2.122%, the lowest close since November 2016. European sovereign yields also rallied during August, closing at low yields not seen in months.

September was a "give back" month, mostly caused by a stronger US dollar. Copper, precious metals, the yen, the euro and Treasury bonds lost value during the month, while oil, agricultural commodities and European stocks were winners. The S&P 500 gained 2.06% during September (total return), led higher by the Energy, Financials, Industrials and Materials sectors, while Real Estate and Consumer Staples were losers. Bonds were slightly lower, led down by Treasuries; the 10-year Treasury bond fell as its yield rose from 2.15% to 2.337%, although corporates were only slightly down, and high yield bonds, following stocks, were higher for the month. Energy was the story of September – after bottoming in late July, oil and energy stocks rallied strongly in September, in spite of a higher dollar.

Equities

Equities closed higher again during the third quarter, with the S&P 500 rallying 4.48% (total return). Winning sectors were mixed, with Technology the clear winner (+8.65% and higher each month), although Energy (+6.84%), Telecom (+6.78%) and Materials (+6.05%) were all very strong. The laggards were Consumer Staples and Consumer Discretionary stocks. After a strong July, stocks corrected slightly during August, especially around Hurricanes Harvey and Irma. However, when Irma missed most large population zones, stocks turned around in September and ended the quarter strongly. Emerging stock markets were up even more than the US markets, taking advantage of a lower US dollar during the quarter; big winners included Brazil's Bovespa (+17%), Russia's Micex, and China's Hang Seng and Shanghai indices. Europe's Stoxx 600 index also had a good quarter, rising 2.3%.

Year-to-date, the S&P 500 has risen 14.24%, confounding analysts and traditional stock studies, not having even a minor correction for over six months. Momentum measures are "off the charts" and a still-sputtering economy (averaging around 2% growth per year) has provided just enough corporate earnings to keep the rally going. Multiples have continued to expand as world central banks (absent the Fed) continue to feed quantitative easing liquidity into the world's financial system. The Fed's announcement of "quantitative tightening" (or "QT") that will start in October, shrinking the Fed's balance sheet by not reinvesting maturing bond principal, will be the next test of whether US markets will correct some without the financial "gasoline being poured on the fire".

Bonds

US Treasuries gained through July and August, as economic news was less than spectacular and a slowdown seemed to loom as hurricanes hit Texas and Florida. However, the economy did not seem to turn down at all in spite of nearly $100 billion in damage, and bond yields rose most of September, showing the renewed economic optimism of the US economy. The 10-year Treasury bond ended the quarter at 2.328%, up from a low of 2.05% in early September. US and European high yield and corporates all gained 1-2% for the quarter as investors embraced more risk and pushed high yield spreads (to Treasuries) to cyclical lows.

Bonds have rallied since the beginning of the year, as economic growth has stayed subdued and foreign central banks have continued buying their sovereign bonds, making US Treasuries relative bargains with more attractive yields than their European and Asian counterparts. Year-to-date, the best performing bonds have been Emerging Market bonds, which have benefited from lower rates and building economic activity around the world.

Energy

After hitting its recent low in late June, WTI rallied strongly in both July and September to close near multi-month highs. WTI ended the quarter up 12% at $51.67/bbl lifted by stronger demand, best indicated by Brent crude being in "backwardation" since August. Backwardation indicates higher current demand, pushing up prices and also drawing down world crude supplies in storage. Year-to-date, WTI crude is down slightly (4%) but has recovered from a late-June low near $42/bbl.

Precious Metals

Precious metals had a good quarter, rising strongly in July and August, although giving back some gains in September. Gold rose nearly 5% for the quarter, ending at $1,281.50/oz while silver was flat. Precious metals equities were strong during the summer but gave up some of their gains in September as reacceleration of risk taking dampened investor appetite for metals in light of no new signs of tightening inflation. Year-to-date, gold is up 10.9% (as measured by the SPDR Gold Trust ETF) while gold miners are up 9.8% (as represented by the Van Eck Vectors Gold Miner ETF).

Other Markets

Currencies were movers again this quarter, with the dollar finally gaining 0.6% in September, ending a six-month losing streak. The euro continued to be the winner, rising as much as 6% during the quarter but finishing only 3% higher. The yen was weaker, ending flat against the dollar for the quarter. The rising probability that the Fed would tighten rates again in 2017, along with the thought that Fed balance sheet reduction would start, added strength to the dollar, helped by the US also showing better economic strength. Year-to-date, the dollar is still down 11% versus the euro and 4% versus the yen. We continue to be interested in shorting both, particularly the yen, because we see a weakening yen helping our long Japanese equities (hedged for the yen) positions.

Going Forward

Economy

The economy continues to seemingly plod along, jumping forward at times but dropping back near stall speed at others. The third quarter preliminary report on GDP indicated 3% growth for the US,

despite two major hurricanes crimping activity. We expect this number to be revised lower as many inputs for the GDP calculation showed marked slowdowns in activity during late August/early September.

Equities

Equities face a test this fall of whether 1) corporate earnings will grow enough to sustain current valuations, 2) monetary stimulus overseas will lead to more investment in US equities, and 3) geopolitical, domestic and nature's shocks will make a difference to investors. One more wildcard is if Congress can agree on a tax package in time for 2017 implementation – various analysts have speculated back and forth about whether a tax package is priced into today's market levels.

As of this writing, October has proven to be another month without any significant pullback, seemingly clearing the way to higher equity markets into the end of 2017. We anticipate adding to our equity exposure when market conditions prove attractive. We continue to be very concerned that there have not been any corrections for months, but market conditions continue to indicate an incredible lack of concern for things that have derailed equity markets in the past.

Precious Metals

Gold has found a headwind during September and October due to the stronger dollar. However, we believe the continuing QE programs in Europe, Japan and China, combined with strengthening inflation and rising geopolitical tensions, will continue to benefit precious metals. The flare-ups involving North Korea and dovish indications about the Fed benefitted gold prices during the summer; we anticipate these types of incidents will continue and may also accelerate. In addition, the gold mining companies we own have continued to improve efficiency, driving down their costs and expanding their margins, as recently evidenced in quarterly earnings reports in late October for most North America-based gold miners. Both the metals and the stocks have been in the quiet early stages of a bull market, rising grudgingly, but rising nonetheless, over the past several months.

Energy

Energy prices have been very interesting. Crude oil, which showed a sawtooth pattern down in price from winter through mid-June, climbed back and broke its downward channel in early September. Heralding this change was the Brent crude futures curve, which moved from **contango** (lower prices in front months, higher prices in back months) to **backwardation** (higher prices for immediate delivery – shows higher demand and discourages storing the product) in mid-August. As the price of backwardation grew and the chart showed a definitive break higher, we bought some oil stocks to capture this new trend. Now it looks like WTI prices are breaking higher, having reached multi-month highs above $54/bbl in late October while Brent crude prices are trading above $60/bbl, a price not seen since mid-2015! We plan to continue to add to our oil-oriented companies as long as the trend persists. Natural gas has not rallied like crude, bouncing up on hurricane-induced supply concerns but falling again on mild autumn weather in October. We will minimize our natgas-oriented

positions. Pipeline stocks have been poor performers, and we don't currently plan to redeploy funds into that sector.

Bonds

Bonds are much more difficult to call here, so we are sticking with positions for those who hold bonds and bond funds, but we are not willing to commit new capital. After starting the year at 2.44%, the 10-year Treasury bond has traded as high as 2.62% in March and as low as 2.05% in early September. As the bond market sensed a stronger economy, yields rose as high as 2.46% in October, but since have started to head down again. A slowing economy and any let up in hawkish behavior by the Fed (seen many times in the past few years) could lead to lower yields. Any increase in indications of future rate hikes acceleration or increased balance sheet run off could lead to rates spiking back up toward 2.62% or possibly higher. We are agnostic about the interaction of those two forces, made even more difficult by potential foreign buying (driving down rates) because of the relative attractiveness of US Treasury rates versus other sovereign bonds around the world.

Other Markets

In currencies, we still believe that the QE effects occurring in Europe and Japan will continue to exert downward pressure on their currencies, either balancing or overpowering the increased economic activity seen in both regions during 2017. The dollar's weakness during 2017 we think is transitory, so we believe being short the yen, and later the euro (and possibly the Canadian dollar, with a weakening economy and a housing bubble that may be starting to deflate) are attractive positions. Last, some of our investors ask us about cryptocurrencies, Bitcoin in particular. They have been strong during the year, weathering weakness and each time coming back to set new highs. Bitcoin is currently $6,100 as we write this; we believe that Bitcoin and the other cryptocurrencies will continue to rise in fits and starts as long as the global QE phenomenon continues to erode the value of traditional currencies and speculative fever continues to run wild in the world. We are unsure of how they will act in a bear market in stocks; that will be the real test that we haven't seen yet. Just as economist Milton Friedman famously predicted that the euro would not survive its first recession (the prediction wasn't right because he didn't predict that European governments would accede to the "rule" of the European Central Bank as they have [most notably Greece, but also Spain and Italy that are suffering from a "stronger than their historical currencies" euro, and not leaving the currency union yet]), we are going to be interested to watch how people treat cryptocurrencies in a real panic in financial assets when there is no government or central bank to attenuate moves down.

Kanos Quarterly Commentary

"Ask the Portfolio Manager"

We usually devote the commentary after the third quarter to a Q & A format because the late October release time is usually a good time to give our opinions and our positioning for the rest of the year and potentially into the new year. With those thoughts in mind, here we go:

Question: What stocks/trends do you find attractive here?:

Kanos: While we have compelling reasons to be cautious (enumerated below), we have seen interesting trends that were/are worth investing in and we understand that people's risk tolerances have expanded as years have passed without meaningful pullbacks which has affected the financial landscape.

Our victories include: 1) **Defense stocks** – we thought both candidates Trump and Clinton would be defense hawks, advocating for a military badly in need of more investment and better systems after being starved for maintenance and innovation by the prior administration; 2) **Biotech stocks** – accelerating innovations in biotech stocks have highlighted the attractiveness of cutting edge medicine, including Car-T immunology and gene editing technologies, both of which we've made money in, 3) **Industrial stocks** – we have felt that undervalued and increasingly busy industrial companies in chemicals and transportation were good candidates for making money and we have been correct in a number of them; and 4) **Japanese stocks** – we have felt that the formerly-overvalued yen forced Japanese companies to become ultra-efficient, and with a weakening yen (which we have also made money on), these Japanese companies have started making large profits, driving up their stock prices and allowing us to profit. We have invested in an ETF that hedges out the yen exposure, which allows us to capture the yen's weakness within our stock position.

Question: Why are you cautious? What has gone up so much in the S&P 500?:

Kanos: As we have presented many times recently, we see the markets as historically overvalued and having many characteristics of being in the late stages of the bull market, so we have wanted to take less risk than those investing in the stocks of the S&P 500 index. A few of our reasons include:

1) Evidence shows that one of the main drivers of the bull market since 2009 has been 500-year lows in interest rates and creation of large amounts of new money; this is now going in reverse (Fed raising interest rates, decreasing balance sheet, both of which lead to decreasing liquidity), which logically should lead to lower equity and other asset prices;
2) Seasonality often plays a part in the movement of stock prices: January is usually an up month (due to new flows) and September is often a down month (due to re-evaluation of earnings estimates for 3Q/4Q). In that vein, the first year of the opposite party's new President is usually a time when the "hangover" from the campaign and incumbent party's fight to retain the presidency usually leads to a slowdown and usually a recession. The fact that it hasn't happened in 2017, despite President Trump's lack of legislative success and nasty political infighting, is surprising and testament to the momentum in this liquidity-fueled bull run;

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3) Historical valuation measures are incredibly stretched. In spite of very low interest rates and lack of real interference from Washington, stocks have not corrected meaningfully in many months. The cyclically adjusted price/earnings ratio gives a good long-term valuation measure for investment periods. It is currently near 30, and 82% above its arithmetic mean, the second most overvalued time besides the 2000 dot.com bubble (and far above 2007 peak). Using sales instead of profitability as a measuring stick (to better include unprofitable companies), the median price/sales ratio at the end of the June was 2.5x, far above 1.8x in 2007 and especially the 1.5x level in 2000.

4) Results have been presented to make them look better than they actually are; Generally Accepted Accounting Principles (GAAP)-based earnings are now usually presented after 'Pro Forma' or 'Adjusted" earnings results, which emphasize positives and downplay or misrepresent negatives. (A good example of this is Amazon's 3Q 2017 earnings just released: Guidance initially started at $2/sh, dropped to $1/sh, $0.50/sh and finally to $0.05/sh. When they reported $0.52/sh, the stock rallied on "the beat", despite operating profit dropping 40% during the quarter and retail margins dropping to -18% before G&A expenses). So, valuations are actually even more stretched than they appear as most analysts use results as presented by companies, not GAAP standards for financial results.

5) Extended cycles have given the appearance of permanence, incorrectly signaling to investors that current investment trends will continue. Since the valuations were manipulated by the central banks (bought $15 trillion of bonds from 2009-2017, artificially lowering yields and boosting liquidity), the signals sent to investors continue to be for low interest rates and a green light for risk-taking. Meanwhile, the Fed (and to a smaller extent, the ECB) are tightening financial conditions which, many times, is the precursor to recessionary conditions and falling financial markets.

Recent S&P 500 gains have been driven by some technology (semiconductor, social media) and financial sectors (online payments, etc.) that have roared skyward with some gains in growth and earnings but the gains scored are out of proportion for the growth exhibited.

Question: What do you think is going to happen to stocks the rest of the year? 2018?

Kanos: We monitor price moves of indices, individual stocks and other financial products. We watch momentum, valuation and sentiment. We also watch the technical situation of both indices and bellwether stocks. Finally, we try to gauge sentiment and positioning in the investment community.

With all that said, we believe that many of those factors are crystallizing for a rise in the large stocks and the major indices not only in the US but also around the world during the balance of 2017. Thus, we are increasing our exposure to stocks as conditions turn more attractive while trying to avoid the euphoria and vast overvaluation of some technology and financial sectors that have been rising lately. Investor confidence has been building for weeks lately, so we still must keep a lookout for sudden pullbacks or danger signals.

For 2018, we believe that continued interest rate rises and Fed balance sheet reductions in the US and less dovish conditions in Europe will put some pressure on the stock and bond markets. The lack of

legislation to come out of the US Government should also start to put pressure on the markets. Finally, more evidence of China's growth, whether it is accelerating or slowing, should help determine the direction of Chinese financial markets, and most probably, the direction of world stock markets. Many believe the pressures for a slowdown and stock market decline that typically happen in the first year of a new different-party President's first term have just been pushed back from 2017 into 2018.

Thus, we expect a correction during 2018 and a revaluation of stocks as earnings slow, although this may not be anything more than a garden variety correction (almost certainly) or something worse (greater than normal probability). See question below for more detail.

Question: What might cause the market to go down? How far would it go down?

Kanos: This, of course, is impossible to know. Most things that have often impacted equity markets have not done so for long this year – the possibility of nuclear war, hurricanes that upset the economy in two large states, higher interest rates and higher energy prices, etc. More traditional danger signs, like high valuations no longer supported by expectations of higher earnings or tax selling in expectation of tax cuts being passed could also push markets down. Another source of possible "market indigestion" are things that are taken as "given" changing: Some of those things include: slowing growth in China, rapid interest rate rises in US (or possibly Europe), a real war breaks out, higher measured inflation rates coming out. As you can see, these are possible but don't seem to be on the immediate radar screen. This has been a "Teflon" market, and it is hard to predict what could hit it.

The other possibility (lower probability, although at a much higher probability than normal), is a much more pronounced decline. Why is it more probable than before? The short answer is the "new" (in this cycle) "easiest" trade of selling volatility. Volatility has been adopted as one of the chief measures of risk, and with years of the Fed injecting money into the financial system and equity investors feeling the Fed was supporting markets, volatility has fallen dramatically. The popularity of volatility as a measure has led to two "innovations" since the mid-2000s: 1) the selling of volatility through the use of listed securities on stock exchanges (if volatility is being dampened by Fed easing, why not sell options on it and collect all the premia?) and 2) implementation of large new institutional strategies that target inflation and grow bigger with lower volatility – such as risk parity (investing in stock and bonds in proportional volatility amounts, adjusted up as volatility drops) and low vol strategies (investing in stocks with low volatility and levering the position more and more as volatility drops). If and when volatility rises, even just to average levels of the pre-2016-17 period, it could lead to large selling to adjust positions/volatility ratios, in which selling could beget more selling, similar to portfolio insurance in 1987.

Question: What have you learned lately that will help you manage our portfolio?

Kanos: We have been paying more attention to technicals to find new trends and to look at how current positions are acting. While we have always used technicals around entering / exiting positions, using them to help gauge the health of the market through the charts of market bellwethers

and sectors is something that has been helping us track market progress and sentiment. In addition, watching developing trends and using those to buy new positions has helped us improve our idea generation and individual stock knowledge.

Question: Tell us about the new system you are implementing.

Kanos: Our new system is called Black Diamond and is the flagship product of the company Advent Data Systems has provided our position accounting systems for many years. It will allow us to get more real-time data and analysis of portfolios, while providing us better end-of-quarter reports (like the one included with this letter) and billing statements for our clients. We welcome feedback about what you think of the reports and what else you might want to see.

Question: What do you see as the trends of the future?

Kanos: We are very excited about the trends in medicine and especially biotech firms developing new forms of immunotherapy and gene editing. We think that these two developments will help cure many diseases and help the body develop new defenses against current and future versions of diseases.

We have also been surprised by the lack of new technological change coming from the traditional tech community. It seems like artificial intelligence and the use of big data should have more uses for you and me, but those seem to be slow to come to market. The AI systems, most notably the one from Facebook, has been deemed a failure due to its clunkiness and disorienting views at times. It will be interesting to see what this technology yields for consumers in the near future, and if it will be productive or just for entertainment.

Finally, the Equifax breach that exposed vital records of up to half of all Americans should have been a clarion call for more and better security for personal information. I have not seen much from people or governmental entities that seem to be tackling this – in fact, Equifax's stock price has rallied strongly from its depressed state, showing investors don't even see the breach as a big risk to the company going forward. We are surprised and disappointed that this incident has not been used to better limit the amount of everyone's data being passed around without knowledge of how well it is being protected. If this movement starts, we would probably start investing in security software companies.

Question: Does anything particularly worry you?

Kanos: The letter does not seem complete without this question being presented. I have three answers:

1) The Yield Curve – the difference in short-term interest rates and long-term interest rates (usually using Treasuries, either the 2-year/10-year differential or sometimes the 5-year/30-year) is often used to gauge the sentiment of the bond market. When the yield curve flattens (2-years and 10-year rates approach the same level), investors are selling short-term and buying long-term debt, which usually happens when economies slow down and/or recession is

approaching. Now the yield curve is the flattest it has been since 2007, having flattened significantly over the past few months. Thus, even though the current economic statistics don't show much slowing, and the stock market is not indicating a big slowdown, the yield curve is showing a big warning sign. The market is as concerned until 10-year rates drop below 2-year rates, an inversion of the curve which would indicate recession coming soon.

2) Low Volatility – as discussed some above, abnormally low volatility in the market for too long (as we have seen lately) changes investors' perceptions (taking on more risk) When volatility rises, it often affects stocks that were thought to have "tamed" past volatility which returns as volatility rises. Technology stocks, due to the advances and obsolescence of the technology world, have been cyclical in the past; were the large tech stocks to return to cyclical valuation levels and volatility measures, the market would move significantly lower. That is a real risk – that stocks act differently when volatility returns to more normal (but higher) levels, ignoring volatility could reach elevated, higher than normal levels, especially after a time of such low volatilities.

3) Debt Levels – debt levels in the US have reached higher than pre-2008 levels, although personal balance sheets are considered to be in better shape. Low interest rates for nearly ten years have allowed people to take on more debt and be able to service it, but as the Federal Reserve raises rates, adjustable rate debt (of which there is a lot because it has been the cheapest with low short-term interest rates) is becoming more and more expensive, putting pressure on budgets (personal and business) as interest rates rise. If they rise too much or too quickly, there could be either defaults or at least selling to lower debt levels. This also applies to the stock market where margin borrowing is at an all-time high, and any decline could cause more selling as investors sell to lower margin debt levels.

The Managers of Kanos Capital Management
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