January, 2018

Dear partners,

Laughing Water Capital (LWC) returned approximately 11.5% net during the 4th quarter of 2017, bringing our return for the full year to 33.2% net. As a reminder, individual returns may vary, so please view your individual statements. **Please note that our lowest cost fee option will be closing to new investors at the end of 2018, or sooner if demand develops as expected**. Upon closing our lowest fee option, we will begin reporting the net performance of our normal class. If you are aware of potential investors that would be a good addition to our partnership, please make them aware of the pending close.

The SP500 and R2000 returned 6.6% and 3.3% in the 4th quarter, bringing full year performance to 21.8% and 14.6% respectively. As always, I remind you that LWC makes no attempt to track the indices, and thus our performance will frequently diverge, sometimes to our benefit, and sometimes to our detriment. For example, the financial media has been giddily reporting that the SP500 did not report a single negative month in 2017. By contrast, LWC posted negative returns in 3 months during 2017. Our portfolio is concentrated, and thus volatile by design. Over longer periods of time the relevance of month to month, quarter to quarter, and even year to year fluctuations will diminish.

In the 2 years since inception, LWC has returned nearly 83% net of all fees and expenses. While we should be pleased with this performance, now is not the time to celebrate. Rather, I suggest investors mentally "bank" this outperformance, and prepare for the difficult times that will surely come eventually. Despite clever marketing schemes and complicated options strategies that suggest otherwise, all investment strategies underperform at times. In my view, how one behaves during the difficult times is perhaps the most important determinant of long term investment success.

Further, these results should be considered in light of three important points. First, two years is far too short of a period to celebrate. As a reminder, we are not re-inventing the wheel. We are simply following the same strategy that the world's best investors followed when they managed small pools of capital. Examining the records of these investors makes it clear that accepting short term volatility is the price of admission for long term outperformance. The strategy works over time because it does not work all the time. If the world's greatest investors suffered periods of underperformance, and even large drawdowns, there is no reason to believe that we will be immune. We must stick true to Buffett's mantra that a bumpy 15% is better than a smooth 12%, and continue to think in longer chunks of time. There is no reason to think that the success of our strategy will correlate to the amount of time it takes for the earth to travel once around the sun.

Second, although the fund has only been in existence for two years, it has now been a decade since I began studying the work of Ben Graham and his intellectual descendants: the same great investors referenced above. The evolution of our strategy has not been a straight path, and it has

taken time to tweak it, and make it my own, but at this point, I think I have it boiled down to the most essential element. Importantly, I believe this essential element is timeless, and will ensure our success for decades to come. The secret is to just say "no" to almost everything. The patient, long term nature of our partnership removes the biggest hurdle to staying true to this secret: short term performance demands. Our partners are an enormous competitive advantage, for which we should all be grateful.

Third, while of course we are happy to beat the market by dozens of percentage points a year, outperformance of this magnitude is not necessary for us to declare our strategy a success. Over longer periods of time, small differences in performance generate large differences in ultimate wealth due to the magic of compound interest. At present, most market forecasters – including Vanguard's Jack Bogle, the world's leading proponent of index funds - are calling for 10 year returns for the SP500 to average 4% per year. If this prediction comes true, and we can generate 7% per year after all fees and expenses, after 10 years we will have ~33% more money than the index. Over 20 years, we will have ~77% more. Over 30 years, we will have ~135% more. While 40+% percent returns are likely not sustainable, and nothing is guaranteed, I feel confident that returns significantly higher than 7% are well within our grasp, regardless of what the market does. This is because our strategy is largely based on exploiting the emotional shortcomings of human nature, with a helping hand from the mechanical shortcomings of the market (for more, see our H1 2017 letter). For these reasons, almost the entirety of my and my family's wealth is invested in our strategy, and we remain the largest investor in Laughing Water Capital. Our interests are aligned.

More on Saying "No"

If the secret to our success sounds silly or simple, consider it in context of how Wall Street functions. The leading brokerage houses (Merrill Lynch, Morgan Stanley, etc. etc.) typically have ~3,000 companies under full time professional research coverage, and ~2,700 of those names are considered worthy of inclusion in a portfolio through a "buy" or "hold" rating. The thesis behind these ratings is typically along the lines of, "we rate XYZ with a buy because we expect quarterly sales to beat consensus estimates by 5%," which seems entirely sensible, (except for the mountain of evidence that suggests attempting to predict quarterly sales is a waste of time). But therein lies the problem. Because they cover so many names, and have a positive opinion on almost all of them, they are forced to label entirely sensible situations as buying opportunities.

In contrast, we are not looking for sensible investments. We are looking for anomalies. In contrast to Wall Street, our typical investment thesis is, "this makes no sense." For example, when we bought EZPW and GAIA, we were buying companies that could be shut down and sold for scrap at prices significantly higher than the prices we were paying for the possibility of continued success. When we bought ITI, we were thinking that if management simply decided to

shut down a money losing business, the stock would double or more. When we bought RKN.TO, we were thinking that eventually the market would value a management team with an excellent long term track record over the impatience of short term arbitrageurs. With FC the thesis is that customers like getting more for the same price. With ADES (introduced below) the thesis is that no one likes paying taxes. There is a simple one or two sentence thesis that accompanies each of our investments, and in no case are we attempting to predict how consumers will behave. Rather, we are just looking for situations that don't make sense.

Despite the simplicity of these theses, they are useless without a cheap purchase price. Further, it is important to recognize that these theses never exist in a vacuum. There are always competing theses. In fact, we deliberately seek out situations where the prevailing thesis is widely recognized, and suggests the company in question is at risk due to some sort of uncertainty tied to operational, optical, or structural problems. The more widely held this view is, the cheaper the shares will be, and the greater the opportunity will be if we are able to determine that the prevailing view is incorrect. In almost all cases, this prevailing view has merit, and we say no to the investment. However, a few times a year we find situations where we are able to develop a variant perception that comes down to simple common sense, and we invest. If we are forced to make guesses about quarterly sales goals as most of Wall Street does, it is easy to say no.

Regardless of our thesis, it is important to recognize that the time of our purchase is the only time we can control price, and we will surely make mistakes in our evaluation of management's ability to solve their problems. Therefore, a cheap price is essential. Once we buy, the market can do whatever it wants. As much as we think that almost all of our investments will get stronger through difficult periods, that says nothing about what their price will do. During market downturns it is common for the market to discard cheap but uncertain stocks in favor of expensive but certain stocks, preferring to "buy high" in the belief that expensive stability is more attractive than cheap uncertainty. For investors that are most concerned with short term performance, this may hold true for a while, but over longer periods of time it should be obvious that buying high is a path to mediocrity. We will always insist on buying low, even though buying low almost always means buying a company with a cloudy near term future. As always, patience is essential.

Top Five Holdings

As of year-end, our top 5 holdings were as follows:

EZCORP (EZPW) – EZCorp, the second largest publicly traded pawn operator, which we first detailed in our Q1 2016 letter, should by now be familiar. In 2017 management executed at an extremely high level, having greatly improved store level performance, strengthened the balance sheet, and aggressively returned to acquisitive growth. Despite this impressive business performance, the stock was a negative contributor to our portfolio until mid-November, and

despite rapid appreciation in the final weeks of the year, EZPW significantly under-performed the portfolio as a whole for the year. This bodes well for our portfolio in 2018, as the market is slowly catching on to what is happening at EZPW, and I am confident that EZPW's intrinsic value will continue to grow. Additionally, this is a recession proof business that will likely anchor our portfolio when the economy inevitably softens.

Fiat Chrysler (FCAU) – We have owned FCAU as a mid-sized position since the inception of the fund, and thanks to its ~85% return in 2017, FCAU has climbed into our top five. While I don't love the auto industry, I do love FCAU's management team, their collection of enormously valuable brands (most notably Jeep and RAM), and their parts division, which I believe will be monetized shortly. Despite FCAU's impressive run in 2017, as of year-end shares remained drastically under-valued, theoretically trading hands at somewhere between 3 and 4 times earnings if one gives them credit for achieving their 2018 goals. This is where Fiat's all-star CEO Sergio Marchionne comes into play, because he has an incredible track record of squeezing real dollars out of theoretically undervalued situations, and I am confident the same will hold true at Fiat.

Gaia, Inc. (GAIA) – We first detailed GAIA in our year end 2016 letter. At the time of our purchase, we believed we were buying a niche Video-On-Demand business for less than free due to the value of the company's cash and real estate. Shares have rallied ~100% since then as the market realized what was happening beneath the surface. This rapid appreciation narrowed the gap between price and value, as well as pushed up the size of our position to a level where I felt it prudent to trim the position size. However, the company is executing very well against their long term plan which they believe will bring them to EPS of $2.50 per share in 2021, and the sustainability of their model is becoming increasingly apparent, so we continue to hold a large – but smaller – position in GAIA.

Iteris, Inc. (ITI) – We attached a slide deck on ITI to our Q2 2016 letter. Shares have come a long way since that time, but the company continues to execute very well, and shares remain materially undervalued as the market has not yet realized that Iteris is leading the effort to develop and deploy the smart infrastructure that will be vital to a future where autonomous cars rule the roads of smart cities. Additionally, it seems likely that the company will seek to sell their agriculture business in the not too distant future. It is very difficult to put a value on this business, but it is not difficult to imagine scenarios where this asset alone justifies more than half of the company's market cap. At times the stock is incredibly volatile – for example, from high to low shares declined more than 30% in a one month period during the 4th quarter – but the unique nature of our partnership positions us well to own volatile stocks that are attached to good businesses, and I am excited to watch ITI's continued execution.

Redknee Solutions (RKN.TO) – Redknee is a niche Canadian software company that we detailed in our last letter. Not much has changed since then, although shares have appreciated ~35%. The road in front of Redknee remains challenging, but the company has already begun executing at a

very high level, and management's incredible track record of success in similar situations suggests a bright future.

New Investments

The fourth quarter again saw more activity than what I expect will be normal over longer periods of time.

Advanced Emissions Solutions (ADES) – ADES entered our portfolio as a small position. At first glance, the company appears to be in the coal industry, which broadly speaking is unattractive, and helps explain the current mis-pricing. However, in reality ADES is in the tax avoidance business. Through a joint venture called Tinuum, the company owns refined coal (RC) facilities that essentially reduce the emissions generated by coal fired power plants. Reducing coal emissions is broadly better for the environment, and broadly impossible to do profitably. As such, the government developed a system whereby operators of RC facilities could generate tax credits to offset their economic losses. Tinuum partners with companies that want to lease or purchase access to the refined coal facilities in order to harvest the tax credits, and thus reduce their own cash taxes.

At present, Tinuum has partners in 17 facilities, and there are 11 more that the company is actively seeking partners for. Under current tax law, RC facilities have a 10 year tax advantaged life, and there are two classes of facilities, those that lose their tax status in 2019, and those that lose their tax status in 2021. The company has been effectively leasing their facilities in recent quarters, and we expect them to be able to add at least one new facility per year through 2021. However, as ADES's facilities are 2021 vintage, it seems likely that 2020 should see a large surge in demand as those companies that are currently engaged with 2019 facilities roll into 2021 facilities. If this comes to pass, I believe we were able to purchase shares at prices that represent a 25-30% annual discount rate to the cash flows that will accrue to ADES – after corporate level expenses - from these facilities between now and 2021.

Further, a recent purchase of an RC facility by another public company suggests that ADES could theoretically be liquidated at a 20% premium to our purchase price. This valuation ascribes a value of $0 to an emissions control chemicals business that the company also owns, $0 to whatever value the RC facilities will have post 2021, and $0 to a patent portfolio that could be valuable as well. Importantly, as cash comes in from the RC facilities, it is being aggressively returned to shareholders through share repurchases and dividends (present yield >10%), and in my view, as long as Benjamin Franklin's observation that "all that is certain is death and taxes" holds true, our investment in ADES should reward us for years to come. It should be noted that this idea was first brought to my attention several months ago by Andrew Jakubowski of Adestella Investment Management.

Greenhill & Co. Inc. (GHL) - Greenhill is a boutique investment bank that has struggled to keep up with the competition in recent years, leading shares to decline more than 70% from their 2013 high to where we added GHL as a mid-sized position. The company attracted our attention because they attempted to execute a levered recap, whereby they raised $350M in debt in order to repurchase more than 50% of their outstanding stock. Importantly, the CEO and Chairman both concurrently invested $10M personally in the company in support of the transaction, and the CEO volunteered to take a 90% pay cut in exchange for equity.

However, the transaction did not go through as envisioned, as there were not enough interested sellers. This creates a situation where we now know there are no sellers in the near term, and we know there is a large buyer, which is generally an attractive setup to step in front of.

To be clear, GHL is in a competitive business and like all of our companies, they face some challenges. However, we take comfort knowing that the two people who know the most about the firm's future prospects have both voted with their wallets in support of a brighter future. Further, banking is ultimately a people business, and GHL has been aggressively recruiting new Managing Directors, and their strong balance sheet and the levered upside of their equity has already strengthened their recruiting pipeline, which will drive revenue.

We presented GHL at the recent MOI Global Best Ideas conference, and have a detailed slide deck that demonstrates why we think GHL could more than double in the coming years, and is unlikely to trade below the failed deal price in the near term. I will be sure to share the deck in a future email, after conference participants have had an opportunity to review it.

Tejon Ranch (TRC) - At 40% of the size of Rhode Island, Tejon Ranch owns the largest piece of contiguous real estate in California. Despite not hosting conference calls or having Wall Street research coverage, the stock is fairly well known amongst value investors because any reasonable valuation of the company’s real estate produces an enterprise value that is substantially negative. However, the stock has often been disregarded due to the belief that, "it is cheap, it has been cheap for a long time, and it will likely remain cheap." It is true that Tejon is moving at a snail's pace in its quest to develop its real estate into 3 residential communities and a commerce center, largely due to the burdensome regulatory environment in California. Properly assessing Tejon's value requires a multi-decade view, which is impossible for almost all investors. However, Tejon entered our portfolio as a small position because in my estimation on an enterprise level Tejon is now trading at the same price it traded at during the financial crisis. As you may remember, the financial crisis was tied to real estate. As such, buying Tejon now is akin to travelling back through time and purchasing valuable real estate in the depths of the greatest real estate crisis in modern memory: an opportunity most investors would jump at. Importantly, while the enterprise value is the same as it was in 2009, the assets are not. It should be obvious that real

estate in general has appreciated since that time, but when looking at Tejon specifically, it becomes clear that Tejon has over-indexed.

For starters, Tejon owns a commercial center approximately 1 hour north of Los Angeles that houses an outlet mall (which did not exist in 2009), as well as distribution centers occupied by the likes of Ikea and Caterpillar. According to the Society for Industrial and Office Realtors, the value of industrial real estate such as distribution centers in the Pacific zone has increased by almost 350% since the spring of 2009. According to CBRE, large warehouse space in close proximity to major urban markets has increased by more than 100% in value over the last 2 years alone, largely tied to increasing demand for next day delivery capability for online retail sales.

Further, Tejon has made significant progress toward breaking ground on their residential communities. Specifically, Mountain Village, the company's exclusive resort-based community which was 50% owned and only a twinkle in management's eye in 2009, is now 100% owned, and received tentative approval – with no appeals - of their tract maps only days ago, a fact that has not been press-released by the company. This means that shovels are likely to be in the ground in a matter of quarters, not years, which should go a long way toward attracting the attention from the investing community that TRC deserves. The change from 50% to 100% ownership clearly represents an increase in value, but equally important is the fact that in 2009 second home values were severely impaired, while in recent years, they have boomed.

Lastly, in October TRC raised $90M through a rights offering, which I believe should carry them through the early phases of construction at Mountain Village, before this development becomes self-funding. Notably, the rights offering was oversubscribed by more than 100%, indicating significant demand from buyers. Much of this demand likely came from TRC's existing shareholders, who are an all-star team of patient, deep value investors. At a time when volatility has been absent from the markets, there is value to investing alongside other investors who are unlikely to panic during a downturn, and recently demonstrated that they would be large buyers at prices close to where shares presently trade. Tejon thus presents an investment with significant upside, and very limited – if any - downside. Further, while there is clearly no guarantee that history will repeat itself, it often rhymes. Tejon has completed rights offerings in the past, and in all cases the market took note that the company was making progress on their multi-decade plan and shares quickly appreciated.

Comments on Select Investments

"You dropped a hundred and fifty grand on an education you could have gotten for a dollar fifty in late charges at the public library." ~ Good Will Hunting

Franklin Covey (FC) – Franklin Covey was introduced as a small position in our Q3'17 letter. In brief, FC sells training materials to corporations based on the best selling book, "The 7 Habits of

Highly Effective People," and is currently transitioning from their traditional one-off delivery method, to an "All Access Pass" where clients can access the entire FC library for one low price.

Interestingly, I received more feedback from readers on FC than on any other position I have publicly discussed. Nearly all of this feedback started with, "have you seen the 47 page short thesis on FC?", referencing a negative writeup on the company that has been making the rounds throughout the investment community. I had seen the piece, and the author is to be commended for the depth of his primary diligence in trying to tell a negative story. However, in my view the author dropped 47 pages on a writeup that could have been 3 pages if it had focused on the right questions.

While the company has faced some difficulties with their transition, our long thesis is based on the belief that 1) customers like getting more content for the same price, and the competition cannot match the depth of FC's offering. 2) It is ok to have some flexibility to your pricing when incremental sales are extremely high margin. 3) Childhood education is different than pharmaceuticals. If the company helps local school boards raise money to improve the local school, everyone wins. There is no parallel to Valeant and Philidor. 4) A recurring revenue model is massively more valuable than the Wile E. Coyote model. More specifically, if successful, FC will have transitioned from a business that falls off a cliff at the first sign of economic weakness to a business that is built on contractual recurring revenue with very high incremental margins, which deserves a much higher multiple than legacy FC.

It is far too early to declare victory on FC, but we are off to a good start as recent results have been strong, and management has recently clarified their vision for the future. Shares are up ~35% thus far, but in my view, remain drastically under-valued.

Growing Our Partnership

I am happy to announce that we added several new individual partners in January, each of whom adds to our collective strength. While the new additions have varied backgrounds including small business owners, corporate executives, and medical professionals, most interesting is the attention we have received from other portfolio managers and investment analysts. This last group generally states that they are attracted to LWC because they recognize that our small size and long-term focus give us a huge advantage vs. the larger funds where they are employed. These larger funds cannot participate in the hidden corners of the market, and often must pander to the short-term focus of the consultants that drive investment decisions at large institutions. Most importantly, all of our new partners are united in their belief that successful investing is based on patiently understanding that price is different than value. It should be noted that in some cases, these investors joined us through a retirement account based at Fidelity, and we are pleased to have established this relationship.

In addition to these individuals, we added a fund-of-funds as an investor. Broadly speaking, I remain suspicious of fund-of-funds and other institutional type investors, who are often at odds with our patient, long term style due to their own unique constraints. However, in this case the primary activity of the managing partner of the fund-of-funds is running a concentrated long biased fund similar to LWC. Unlike many institutional type investors, he understands that a long investment horizon is one of the few advantages that any investor can have. There is no doubt his interests are aligned with our own. As he says, he is not chasing performance, he is chasing original thinking and asymmetric opportunities, which in my view is the foundation upon which great performance is built.

Our assets remain well below the level where they will hinder our performance, but they have surpassed the point where the long-term sustainability of our partnership is in question. As such, our lowest fee option will be closing in the coming months. If you are aware of individuals, family offices, or other mini-institutions that are forward thinking enough to recognize the tremendous advantages that our small partnership has, please feel free to suggest they join our mailing list by visiting www.laughingwatercapital.com, or contacting me directly at MSweeney@LaughingWaterCapital.com

A Brief Word On Cash

The addition of new partners has meant a substantial infusion of cash into our partnership. Simply stated, in the short-term cash is a negative if the market is rising, and a positive if the market is falling. Thus far in 2018 it has been a negative, as the SP500 is off to its best start to the year in 30 years, and several of our portfolio holdings leaped upward at a time when we were under-invested. Fortunately, LWC is designed to be indifferent toward short term performance, and in my view the optionality represented by cash is grossly underappreciated by investors. As such, while I have been patiently deploying some of this cash to round out existing positions, I am happy to hold the balance secure in the knowledge that over the last several years, once or twice a year I have been able to find an investment opportunity that simply did not make sense, regardless of what the market was doing. If we can find another such opportunity this year, whatever drag we suffer from our cash position in the short term will have been well worth it.

Looking Forward

As always, I have no idea what the near-term future will bring, and I suggest that you regard anyone who claims to have the answer as a liar or a fool. The market is not historically cheap at the moment, and the lack of volatility in recent months will surely not last forever. At the same time, for the first time in a long time it seems clear that animal spirits are running wild thanks to the low tax/reduced regulation environment. In my view, attempting to sort out these apparently

opposed forces is a waste of time as history has shown that the market can remain at elevated valuations for years, and attempting to time the market for a lower entry point is not an effective strategy.

However, our common-sense approach to owning good businesses, run by incentivized managers, that are likely to be long term beneficiaries of any short term economic or market downturns, when they are on sale, is an effective strategy, regardless of what the market does. We will not be immune from the inevitable downturns, but we will be well positioned to take advantage of them. In fact, while I have no idea what the next year will bring, I feel better about the multi-year prospects of our management partners and their businesses today than I did going into 2017. Additionally, while our large cash position has been a substantial drag in the early days of 2018, I have no doubt that it will be deployed into very attractive opportunities in the months and quarters to come. These opportunities may come in the form of a broad market pullback, or they may come in the form of complete anomalies created by the failings of human nature that always exist if one looks in the hidden corners of the market. As always, I believe the best strategy is to continue to iterate our process with a focus on the long term, confident that over time, good businesses run by incentivized managers available at cheap prices will generate acceptable investment results. If you have any questions, please do not hesitate to contact me.

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