SAGA PARTNERS

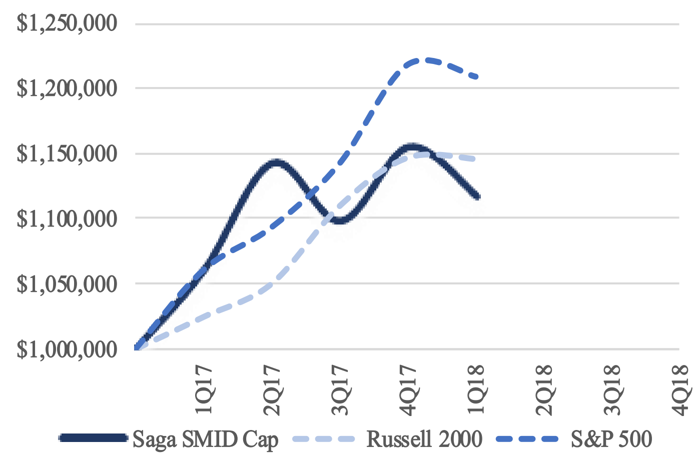
QUARTERLY REPORT

FIRST QUARTER 2018

1Q18 Results

During the first quarter of 2018, the Saga Portfolio ("the Portfolio") declined 3.3% net of fees. This compares to the overall decline, including dividends, for the Russell 2000 and S&P 500 Index of -0.1% and -0.8%, respectively. Since inception on January 1, 2017, the Saga Portfolio returned 11.7% net of fees, compared to the Russell 2000 Index and the S&P 500 of 14.5% and 20.9%, respectively.

Growth of $1 Million



Performance (net of fees)*

	Saga SMID Cap	Russell 2000	S&P 500
1Q17	6.1%	2.5%	6.1%
2Q17	7.7%	2.5%	3.1%
3Q17	-3.9%	5.7%	4.5%
4Q17	5.2%	3.3%	6.6%
2017	**15.5%**	**14.7%**	**21.8%**
1Q18	-3.3%	-0.1%	-0.8%
Since Inception	11.7%	14.5%	20.9%

**Saga Portfolio performance calculated net of fees, using Modified-Dietz method. Russell 2000 and S&P 500 performance includes dividends.*
Source: S&P Dow Jones Indices LLC, FTSE Russell International Limited.

Interpretation of results

The first quarter ended the extended period of historically low market volatility. The market shifted from excitement over lower corporate taxes to fears of higher interest rate and inflation expectations, and more recently to talks of trade wars. All of this is interesting to read and talk about, however it does not have any major influence in our day-to-day investing decisions.

In the short run, stocks can swing wildly based on unimportant and unpredictable factors. Much like a private business owner who does not get daily quotes on the price of their business, we are agnostic to daily stock movements. What we do care about is the fundamental performance of the companies we hold. This does not necessarily mean earnings per share, though we inevitably expect our holdings to generate cash flow to shareholders. We care whether the company is increasing its competitive advantage, or "moat". Over the long run, a company's stock price will increase in-line with the growth in intrinsic value of the business.

We make no attempt to forecast either business or stock market cycles. The news, business publications, and talking heads on CNBC generally focus on the movements of macroeconomic indicators, attempting to use them to predict how they will impact the markets.

Macroeconomic variables can have a very real impact on the earning power of individual companies. However accurately forecasting these variables and subsequently knowing how they will impact a specific company is beyond our ability. Economic markets are complex systems with infinite interdependent variables working together. We prefer to not waste time analyzing things we cannot know or predict and instead spend our energy on what is potentially knowable, such as the underlying *microeconomic* fundamentals of a company.

Investing Process

Traditional "value stocks" are considered to have low valuation multiples relative to earnings, cash flow, book value, or some other financial metric. In our experience, low multiple stocks often deserve their valuation whether due to their lower quality or unpromising outlook. While historic operating metrics can often be used as a proxy for future performance, they are not always representative of results to come, therefore recent results can provide misleading valuations. Today's share price is the sum all the *future* cash that can be taken out of the company, discounted at an appropriate rate.

We focus first on the qualitative characteristics of a business to evaluate if it has a durable competitive advantage. We must feel confident about the company's earnings power in five or ten plus years. Only after we determine a company meets our qualitative standards do we move on to quantitative analysis to determine the estimated intrinsic value.

For any new and existing positions in the Portfolio, we essentially have four main investment filters:

1. A company we understand and will be around and prospering in 10+ years?
2. Is the company building a durable competitive advantage?
3. Is management high caliber and aligned with shareholders?
4. Does the current price provide an attractive return if the company is owned for 10+ years?

If a company meets our four simple filters, the degree of uncertainty, or risk of permanent capital loss over the long term, greatly diminishes. While these filters can lead us to ideas that may not screen as traditional "value stocks," our experience has shown they lead to the highest returning ideas while greatly reducing the risk of permanent capital loss over the long term.

The best companies, i.e. *franchises*, consistently earn high returns on capital. A franchise is a company that provides a product or service that; 1. is needed or desired (demand), 2. customers think or believe has no close substitute (moat) and, 3. pricing is not subject to regulation (pricing power).

These characteristics provide the ability to price a product or service above the company's cost of capital, and therefore earn excess returns. Economic theory suggests competition would lower excess returns, however possessing all three of these qualities can protect against competition. Alternatively, a commoditized business only earns high returns on capital if it is a low-cost operator or if supply for its product/service becomes tight, allowing the firm to raise prices. Inevitably, competition increases, tight supply ends, and excess returns on capital disappear.

For example, the five largest U.S. companies by market cap- Apple, Google, Microsoft, Amazon, and Facebook- essentially require no capital to operate. In certain parts of their businesses they have the three franchise qualities, providing them a moat and the ability to earn high returns on the nominal capital invested. That said, a strong business only becomes a strong investment at the right *price*.

While there may be several different types of moats, they essentially come down to one important variable, barriers to entry. In his book *Competition Demystified*, Bruce Greenwald does a great job defining a barrier to entry as an incumbent firm's ability to do what potential rivals cannot. It boils down to three key advantages:

1. **Demand**: Customer captivity either from customer habit, switching costs, or search costs.
2. **Supply:** Ability to supply products at a lower cost than competitors such as through proprietary technology, experience, supplier agreements, etc.
3. **Economies of Scale**: Ability to reduce costs per unit as volume increases, spreading fixed costs over a greater number of units sold.

A company usually falls somewhere in between a franchise and a commoditized business. Moats are constantly under attack and the competitive environment often shifts as technology advances. What once looked like a high returning franchise such as local television broadcasters or newspapers can quickly turn into a less attractive commodity-like business.

Conclusion

While past updates about the Portfolio were more brief, we plan to spend a little more time discussing our investment philosophy and providing more color on specific holdings going forward in order to provide a greater level of transparency and understanding about how the Portfolio is managed. If you have any questions or comments please reach out, we are always happy to hear from you.

Sincerely,

Joe Frankenfield

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