

“The best time to buy a compounder was ten years ago. The second-best time is today”

Overview

The Qualivian Focus Fund is an **investment partnership focused on long-only public equities**. We own a concentrated portfolio (15 -25) of understandable companies with **wide moats**, long **reinvestment runways**, and **outstanding capital allocation**. We expect them to **compound capital at a mid-teens rate and hold them** for an extended period. We **have a private equity approach to public equities**. **We are seeking investors that are aligned with our long-term horizon**. We do **not short securities**. **We do not take on leverage**. We are not macro investors. The fund primarily focuses on US companies of all sizes but can have 20% of its portfolio outside the US.

We buy carefully. We sell rarely. As per Warren Buffett, we believe the stock market is a mechanism to transfer wealth from the impatient to the patient. High quality assets with durable and growing cash flows are rare in a world awash in low and negative interest rates. When they are run by able management teams with excellent capital allocation, they are rarer still. We are quite comfortable sitting back, holding on, and watching the power of compounding work. The big money is made in the waiting not in scratching the itch to “do something”. We don’t mind watching paint dry.

Our formula:

Long-Term Orientation+ Long-Term Investors + Focused Portfolio + Quality Compounders = Maximizing Chance for Outperformance.

Our investors should understand how we invest so they make the right decision (both for them and us). We are not right for all investors. We would encourage shareholders aligned with our long-term horizon and philosophy to contact Aamer Khan (aamer.khan@qualivian.com) at 617-970-9583 or Cyril Malak (cyril.malak@qualivian.com) at 617-977-6101.

This letter discusses our Q4 and full year 2019 performance, recaps our core beliefs and thinking, and discusses an existing and a potential portfolio holding.

Performance of the Fund in 2019

In 2019 we finished up 40.2% and 39.4% on a Gross and Net basis respectively, versus the S&P 500’s performance of 31.5%, or an outperformance of 8.7% and 7.9% respectively. We have outperformed the S&P500 each quarter in 2019: in Q1 our outperformance on a Gross and Net basis was 4.0% and 3.9%, in Q2 it was 1.0% and 0.9%, in Q3 it was 0.7% and 0.5%, and in Q4 it was 1.4% and 1.3% respectively.

Since inception of our fund in December 2017 through December 31, 2019, we returned 35.0% and 33.3% on a gross and net basis. The S&P 500 returned 26.3% in the same period. Appendix 1 contains a detailed quarter by quarter performance table.

Happy as we are with these results, we would caution our investors that smooth, quarter by quarter outperformance is unlikely to be repeated in the future. Even if it is successful, the desire to manipulate portfolios to have smooth quarterly outperformance is the enemy of long-term outperformance. Remember - no winner of the Tour de France has ever won every stage. We think you should judge us by our cumulative results over a 3 to 5-year period in line with our anticipated average holding periods for our stocks. Quarterly results will be lumpy.

In 2019 the number of holdings has fluctuated between 15-17. Some of our top contributors are well known large cap names in whose long-term competitive advantage we have confidence, and which we think will outperform the S&P 500 over the next 3-5 years. We prefer buying what we can understand well over buying esoteric names with trendy business models that are harder to figure out. Regarding investment candidates, what should matter is the quality of their franchises, and not their novelty. Sometimes the two get confused, because there is a link in some areas, like art or poetry. We don’t think there is a link in investing.

Our top 3 contributors in 2019 were Mastercard (MA), Moody’s (MCO), and Apple (AAPL). Our bottom three contributors were Altria (MO), Booking Holdings (BKNG), and Nordson (NDSN). It is interesting to note that our

bottom 3 contributors were still positive contributors to the fund. Since inception our turnover has been low, averaging 20% per year. Names we added to during the year were Brookfield Asset Management (BAM) and Broadridge Financial (BR). Names we exited were Nordson (NDSN), Alibaba (BABA), Altria (MO) and Booking Holdings (BKNG).

The names we exited in 2019 were:

NDSN: a fine industrial company which we highlighted in our Q2 2019 investor letter suffered from an extended down cycle in its high margin mobile electronics segment that sells adhesive dispense and chip testing equipment into the mobile handset market. This in combination with the change in the long-term CEO at the helm, Mike Hilton, in mid-2019 reduced our confidence in our ability to forecast NDSN's long-term growth trajectory. We continue to monitor NDSN and await to understand the new CEO's strategic priorities for the company going forward. We used the proceeds from NDSN to largely fund our position in Brookfield Asset Management, which we think has a more sustainable long-term earnings growth and greater potential upside in the stock.

BABA: This was a stub position since we exited much of the position in 2018. We were attracted by the strength of its platform, its scale, and its founder-led mentality. However, we felt that BABA's legal form, a variable interest entity (VIE), combined with uncertainty in the US China business and trade relationship, diminished our confidence in looking out 3- 5 years.

MO: This was a mistake to begin with, in retrospect. We were attracted by its high returns on capital, plentiful cash generation, and oligopoly position. Its acquisition of JUUL, which it had to write down, demonstrated poor capital allocation

BKNG: We owned Booking since the fund's inception as we were attracted by the attractive virtual cycle generated by the company's two-sided network in travel, and especially its core holding, Booking.com, which had a stronghold on the attractive European travel bookings. Booking exhibited superior growth, margins, and returns on capital but we became increasingly concerned that the growth and margins were being increasingly assailed by Google, historically BKNG's largest search ad distribution platform.

New names we added were:

BAM: A leading alternative asset manager which has a leading position in alternative asset classes like real estate, infrastructure, and renewables. Its scale, scope and network give it a competitive advantage over other alternative asset managers. Its management team has demonstrated outstanding capital allocation since inception. It has a huge runway for growth given the demand for alternative assets since other asset classes are unlikely to meet the return thresholds required by pension funds, endowments, etc.

BR: Broadridge Financial, a global Fintech leader, provides the financial industry with outsourcing services and software solutions, including investor communications solutions (proxy distribution and processing), as well as securities processing and clearing services. It occupies the dominant services position in the Investor Communications market and in its capital markets business, with very high recurring revenue, resulting from multi-year sticky customer contracts that benefit from high customer retention rates of 98%+. Furthermore, the company drives strong operating leverage from its high single digit topline growth to drive mid-teens cash earnings growth consistently.

We are bottom up investors. However, much of our portfolio has naturally segmented into several buckets:

Platforms: Double sided platforms benefit from network scale effects, are capital light, and highly cash generative. Each incremental addition to one side increases the value of the platform to the other side, increasing the likelihood of that side attracting more members to the first side, creating a flywheel effect. They also benefit from positive optionality since businesses not yet invented may use their platform providing other potential cash flow streams. Their capital expenditure is limited or even sometimes negative because they benefit from the investments of those

businesses that currently use their platform. Current GAAP accounting distorts their economic earnings because it treats some investments as operating expenses that should be capitalized on their balance sheet and amortized over the life of those longer-term assets. This makes them look optically more expensive than they really are. We have written on this theme in our first quarterly letter.

Digital Transformation: Increased computing power, mass proliferation of communication devices and sensors, and increased connectivity has driven and continues to drive digitalization. The confluence of four technologies - cloud computing, big data, artificial intelligence (AI), and the internet of things (IoT) is fundamentally changing how organizations will operate and resulting in value shifts from one group of firms to another. Today we are seeing a burst of evolutionary change - a mass extinction among firms and a mass speciation of new kinds of business models. The key for investors is to identify the beneficiaries of these shifts and assess their duration and strength. We are still in the early innings of digital transformation. Given the exponential nature of the growth of this trend, we see it continuing for the foreseeable future.

Owner led businesses: There is substantial evidence that businesses led by founders outperform those led by hired management teams. We have a bias towards these founder-led firms. Research by consulting firm Bain, shows that companies maintaining a founder's mentality as they mature are four to five times more likely to be top quartile performers in shareholder value creation¹. An index of S&P 500 companies in which the founder is still deeply involved performed 3.1 times better than the rest over the last 15 years. This is because of (1) **business purposiveness** which often gives the business a meaning other (and higher) than just making money, (2) **front line presence** which shows up in a hands-on mentality, a love of the details, and a culture that empowers those on the front line, and (3) **owner's mindset** which is acting speedily, and taking personal responsibility for risk, innovation, and cost, and without it, companies become self-satisfied, slow, sclerotic, inward focused, and risk averse.

Concentrated Investing: Slugging Percentage versus Batting Average

Are there evidence-based experiments regarding concentrated investing that are not just back tests of different investment rules? Yes: the following experiment was described in Freeman-Shor's book *The Art of Execution*.

Over seven years, 45 of the world's top investors were given between \$25m and \$150m to invest by fund manager Lee Freeman-Shor. His instructions were simple. There was only one rule. They could only invest in their ten best ideas to make money. Over a period spanning more than seven years, from June 2006 to October 2013, he examined 1,866 investments, representing a total of 30,874 trades made by 45 of the world's top investors – all of whom he had the privilege of managing as part of his job as a fund manager at Old Mutual Global Investors. What was unique about these 1,866 investments was that each one of them represented the best money-making ideas of these distinguished investors during those seven years. The rationale for doing so was the simple belief that the greatest possible returns on capital could be achieved by hiring the best investors and letting them invest in their top ideas exclusively.

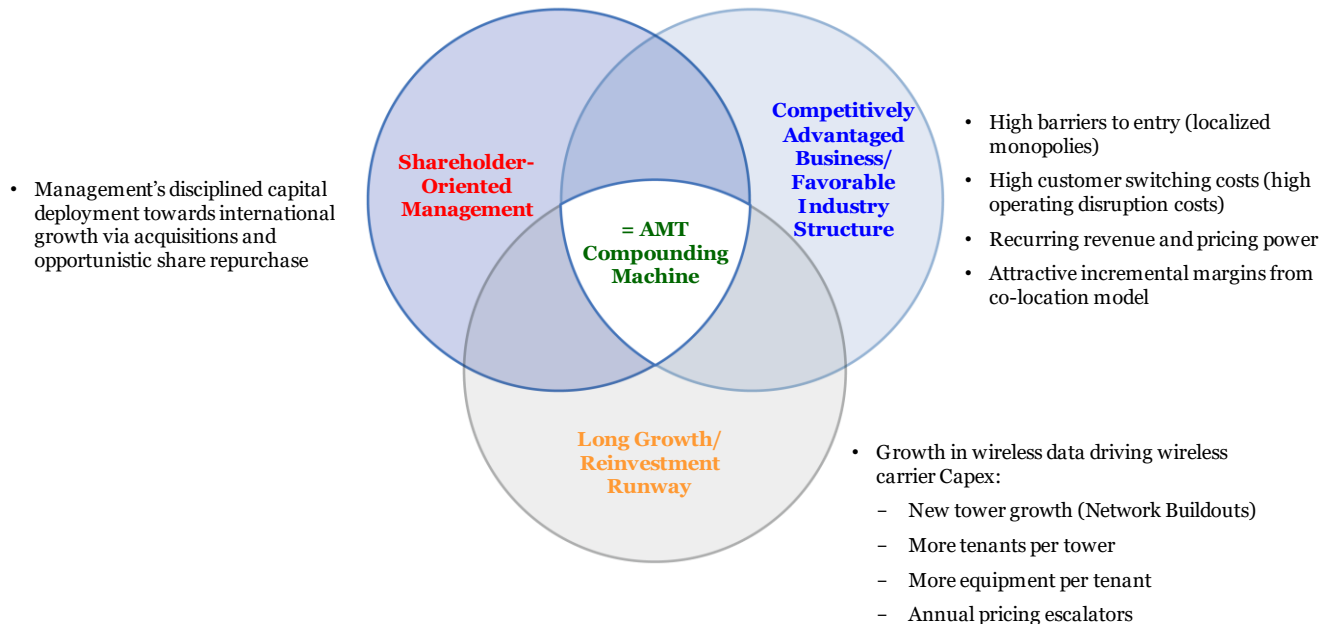
What Happened: The group was divided into different “investment tribes”. The most successful tribe was designated The Connoisseurs. They had a lower hit rate (percentage of picks that made money) of 40%, which was lower than the entire group. But when they won, they won big (slugging percentage) and allowed their winners to be a bigger percentage of their portfolio than other investors were comfortable with. They focused on stocks that had sustainable earnings growth, even at the risk of purchasing them at a high multiple. If they made a mistake, the earnings growth would cushion the impact of the compression in the P/E ratio. With average stocks, a reduction in earnings and P/E ratio often happened simultaneously, creating a double whammy. When they were confident in their idea, they built up a large position. The Connoisseurs were not interested in small scale success.

They also had a high boredom threshold. They did not mind doing nothing for an extended period. Sometimes they discussed the same stock with the author for five years or more. This requires discipline rarely found in this quarterly performance-obsessed, action-oriented, social media saturated investment environment we are in.

¹ *Harvard Business Review*, “Founder-Led Companies Outperform the Rest – Here's Why,” based on a research study by Bain and Co., 3/23/2016.

We now discuss an existing portfolio holding and one that is on our radar screen in the sections below: American Tower (AMT) and Tyler Technologies (TYL). We have owned AMT since the inception of the fund (and previously highlighted it in our H2 2018/Q1 2019 investment letter. Tyler is a company we have been following for a while and we are waiting for a more advantageous entry point.

American Tower (AMT): The Reinvestment Opportunity Explained



We cannot emphasize enough **how important the ability to reinvest capital at a high return is for value creation**. It is one of the defining characteristics of a quality compounders. It is a characteristic that many investors miss, to their detriment, when they analyze firms. We would like to illustrate the high return reinvestment opportunity with one of our holdings, American Tower (AMT), which we featured in our H2 2018/Q1 2019 investor letter. For a deep dive into the end-market growth drivers and overall thesis please refer to that letter (and if you do not have a copy of that letter, we can certainly provide you one).

A recap of our Investment Thesis: (1) AMT operates in a favorable oligopolistic industry with cell tower sites that are effectively local monopolies benefitting from high customer switching costs, which gives it sustainably high returns on capital, and discourages new entrants, (2) AMT has an enormous growth runway due to increased capex spend from the domestic and international telecommunication companies driven by the exponential increase in wireless data in developed countries and growth of mobile voice and data services in international markets, and (3) a management team with a clear focus on shareholders and a history of intelligent capital deployment. A suitable analogy would be a fruit orchard, where the expense of planting a tree is incurred today, but the benefits take several years to come through. Now if the fruit orchard is growing, and the yield of the trees is increasing, that makes it an attractive business.

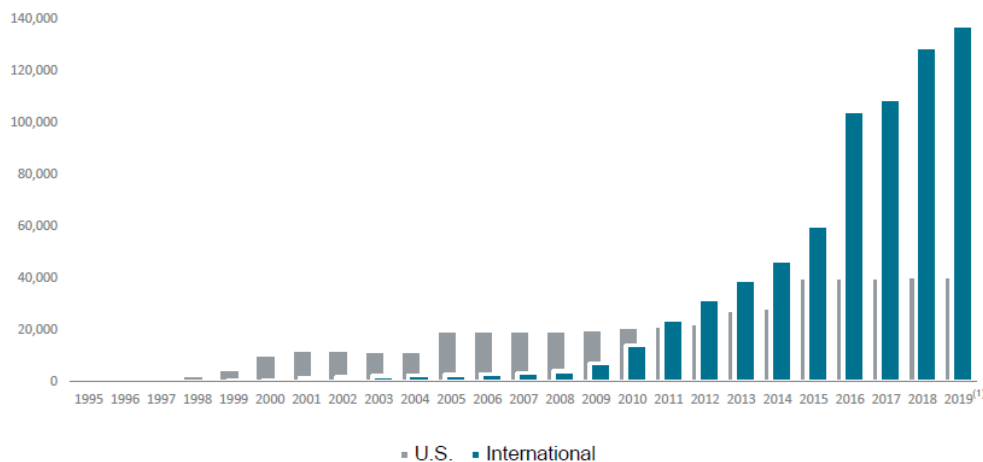
$$\text{Value of AMT} = \text{Value of existing US and International Business} + \text{Value of US Reinvestment} + \text{Value of International Reinvestment}$$

Reinvesting in International Markets

As AMT continued to scale up its maturing US tower portfolio, it began to simultaneously reinvest the cash flow from those operations in entering and scaling its presence in key international markets. Given the competitive landscape and lower risk profile in the US, AMT was targeting unlevered returns on capital (ROC) in the high single digits and levered returns (ROE) in the high

teens at maturity, in key international markets it saw opportunities to reinvest at low to mid-teens ROCs in key markets like Mexico, Brazil and India, and even high-teen ROCs in riskier milieus in Africa and Asia.

Exhibit 1: U.S. and International Tower Counts



Optically, AMT’s international cell towers are less profitable than its US cell towers. AMT currently has 75% of its towers in international markets, which constitute only 50% of revenue and 40% of its gross profits. However, there is embedded growth in revenues and in profits, that will generate increasing returns on capital over time in the existing assets as those assets mature, as well as expansion opportunities in AMT’s existing and potential new international markets.

Where does the embedded growth in the existing assets in international markets come from? AMT’s international wireless markets are 5-10 years behind the US relative to their roll out and densification of their networks. On average, AMT’s international portfolio has 1.5 tenants per tower vs. 2.7 in the US, with many of these markets just now beginning to roll out 4G networks and others beginning to densify (both adding towers and adding more tenants and equipment per tower).

To make the answer more tangible, it’s important to illustrate cell tower economics and the enormous embedded operating leverage as cell towers mature.

Exhibit 1: AMT Illustrative Tower Economics (US case study)

	Tenants		
	First	Second	Third
Construction / Upgrade Costs (US \$)	\$275,000		
Cumulative Tenant Revenue	\$20,000	\$50,000	\$80,000
Operating Expenses (incl. lease exp, utilities, and monitoring/security)	\$12,000	\$13,000	\$14,000
Gross Income	\$8,000	\$37,000	\$66,000
Gross Margin %	40%	74%	83%
Gross Margin Conversion Rate from additional tenant(%)		97%	97%
Annual Maintenance Capex	\$1,500	\$1,500	\$1,500
NOI Yield pre-Maint. CapEx (%) ⁽¹⁾	3%	13%	24%
NOI Yield post-Maint. CapEx (%) ⁽¹⁾	2%	13%	23%

⁽¹⁾ NOI Yields are simply Tower Rents less direct operating expenses divided by construction/acquisition costs or capital employed. NOI yields are illustrative of ROICs.

Exhibit 2: Typical Tower Construction Sites

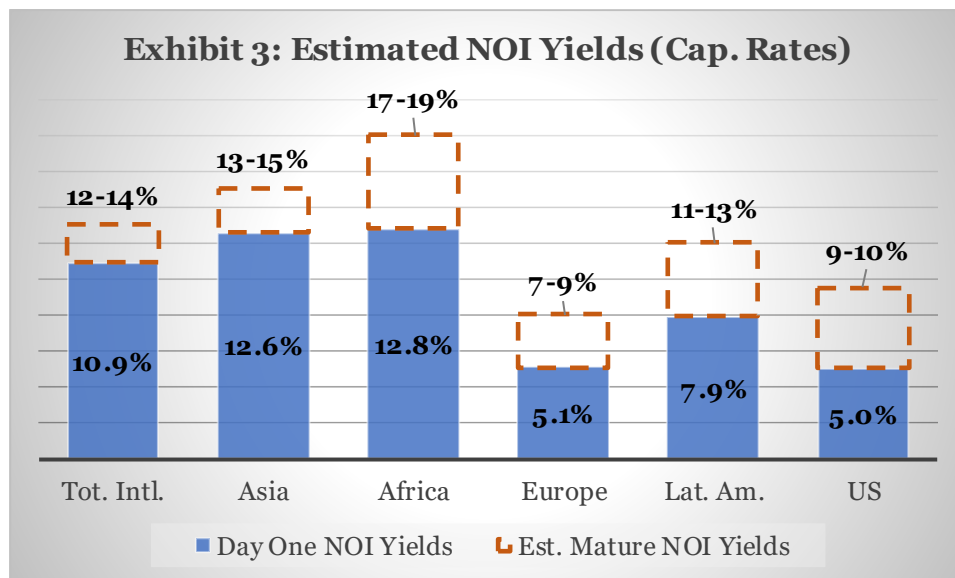
US	LatAm	Africa	Asia
\$250-300K	\$85-170K	\$60-120K	\$20-30K

The takeaways from Exhibit 1 are quick to see. At the outset, new towers generate low returns on invested capital but the marginal contribution from an additional tenant is 95%+ given the negligible incremental expense to support that customer. Returns on capital quickly rise from low single digit levels for a single tenant (“Day One Returns”) to 13% with two tenants to 24% with three tenants. It’s important to state this is a simplified illustrative view because it is a static view. When you layer on annual price

escalators and amendments (additions of equipment by existing customers to a tower) over time, the accretion in returns is even more beneficial than shown above as those incremental revenues are achieved with little to no additional expenses.

International Tower Economics vs. the US

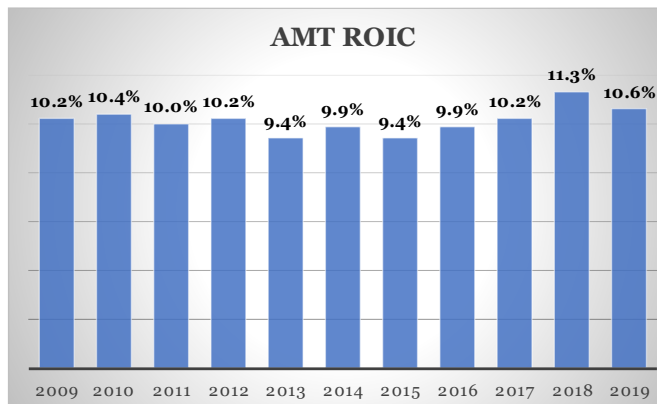
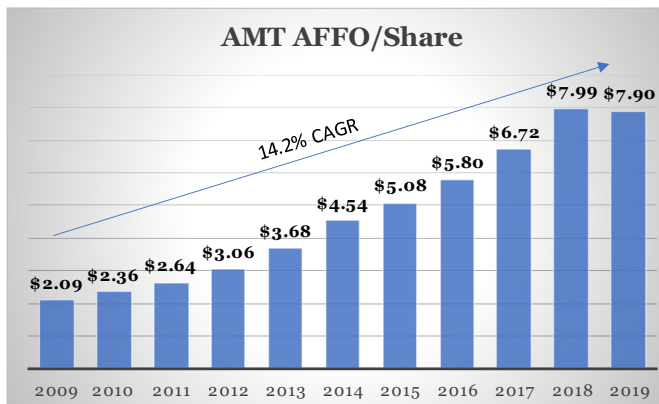
With this insight in mind, the graph below illustrates Day One NOI Yields/Returns² versus AMT’s targeted returns for their towers at maturity and you can see that the International tower portfolio in many geographies has superior returns even at Day 1 economics versus the mature returns in the US which we estimate to be in the 9-10%. Their absolute dollar contributions are lower today because of lower rents than the US but also because they are at a lower level of maturity (1.4X tenants vs. 2.7s tenants per tower), and also because they are 5-10 years behind in building out and densifying their networks. As that happens, not only will there be more tenants per tower but also more equipment per tenant per tower both of which we expect will generate highly profitable incremental revenue streams from the existing international assets over the coming years.



Furthermore, nominal returns in International markets are stronger than in the US because both new construction and operating and maintenance costs are lower than in the US (see exhibit 2). While it is hard to generalize across all the different International markets because we do not have the detailed data by country by client, generally speaking both up front capital costs (as indicated above on new construction as well as in typical acquisition prices are less than in the US) as well as operating and maintenance capital are typically much lower than in the US. As an example, in India, rents are typically \$7-8K for the first tenant vs \$20K in the US but the cost to build a tower is typically \$50K (vs. \$250K here) and annual maintenance expense is estimated at \$500 (vs. \$1.5K in the US). Operating costs are also significantly lower than in the US. Once tower portfolios reach maturity, as networks generate more co-locations (more tenants per tower), more amendments (more equipment per tower) as well as annual escalators, we estimate that AMT will be able to generate ROCs in the 13-15% range and in riskier markets in Africa, AMT is targeting fully matured returns on capital in the high teens.

The expansion and maturation of AMT’s US tower assets over the past decade has allowed it to simultaneously invest in International markets to extend its growth and returns over the coming decade, resulting in AFFO/sh compounded growth of 14.2% while multiplying its tower assets seven fold, while still increasing its ROIC by 60-bps through this heavy investment cycle.

² AMT Financial and Operational Update Investor Presentation, Q4 2019.

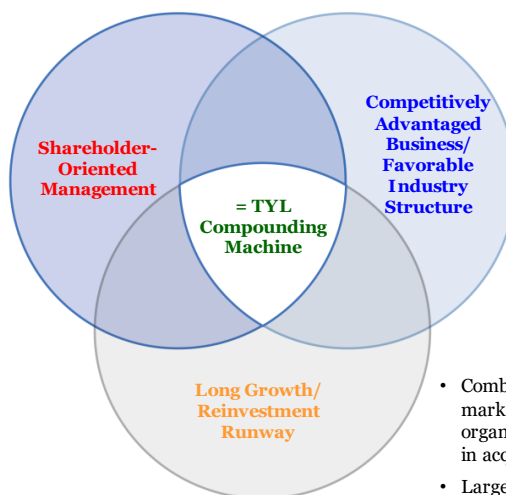


Final Thoughts

We therefore expect that as AMT’s International portfolios start maturing over the next 5-10 years, they will replicate the margin and return accretion that their US tower portfolio counterparts experienced here over the past ten years. This in combination with US towers continuing to benefit from annual price escalators and amendments as carriers continue to invest in their 4G networks over the next 3-5 years to accommodate the annual growth in mobile data and as they begin rolling out 5G networks in the next few years. As a result, we see sustainable low teens revenue growth and mid-teens AFFO/share growth (cash earnings growth) over our typical 5-year investment horizon.

Tyler Technologies (TYL)

- History of accretive acquisitions for cash
- Routinely walks away from or loses auction transactions due to pricing discipline



- Leading national Finance/Admin ERP and specialized government applications software provider.
- Exclusive focus on local and municipal government verticals with its own consultants, giving the company an advantage over the larger generalized ERP software firms (SAP, Oracle) and smaller, specialized public sector firms

- Combination of 8% end-market growth and sustainable market share gains has allowed TYL to grow revenues organically in the low-teens, supplemented further by tuck-in acquisitions, resulting in mid-teens top line growth
- Large national ERP firms are ill equipped to serve the niche vertical local and municipal government markets that TYL specializes in, giving it the brand names and the momentum in the space
- Smaller government-focused specialized software competitors typically address one vertical and therefore cannot offer the breadth and depth of TYL's offering
 - These types of companies are often acquired by TYL as they fill in product/capability or customer gaps

TYL sits at the sweet spot of what we look for in an investment: a wide moat, excellent returns on capital, a large runway for growth, and a shareholder centric management team. Tyler is the leading provider of software solutions to municipalities, local governments, and states. The total size of the market is \$20 billion (and 450K systems) and Tyler's segment of the market is \$9 billion. Tyler's current revenue is \$1.1 billion. We have been following TYL for a while, and while it ticks many of our investment criteria boxes, we are waiting for a more advantageous valuation entry point.

Investment Thesis:

1. **Long Growth Runway:** Of the 450K installed systems in Tyler's footprint, only 150K have been installed by competitive software vendors. The rest are home grown systems, unsupported systems, and systems more than 20 years old that use out of date languages like COBOL. Local governments, being change averse and budget constrained, stick with antiquated systems and have little incentive to install new software, as compared with for profit businesses. Change tends to happen only when the software stops functioning, is no longer maintained, or cannot fulfill baseline requirements like compatibility with Excel or Word. The average age of a system that Tyler replaces is 20 years. In some cases, Tyler has replaced mainframe systems 40 years old. This leads to a huge potential market. Tyler's total addressable market is around \$9 billion, growing at around 8% per annum, and with its track record of gaining market share, it has and will continue to grow organically at 10%+ for years to come. Furthermore, that organic growth is often supplemented by acquisitions that fill-in product capabilities in different government verticals, allowing to grow revenues at mid-teens and EPS at mid- to high-teens plus
2. **Sticky Clients leading to High Retention Rates:** Very few municipalities go bankrupt or get acquired by another organization that replaces the existing system. Once a system is sold by TYL, it will be around for a very long time. When there is a rare defection it often comes from towns whose population has shrunk and cannot afford maintenance of their systems. As a result, TYL's customer churn rates are very low at around 2%.

3. **Competitively Advantaged with Entry Barriers:** Tyler is the largest national software vendor focused exclusively on the public sector which grows around 8% per annum. It has grown revenues by 16% per annum over the last decade due to the strength of its offering. In comparison with the private sector, public sector sales are characterized by longer duration of the sales process, smaller size of the deals, and lower margins. These constitute a substantial entry barrier to the big ERP names like Oracle, SAP, Infor, and Thomson Reuters who prefer to focus their resources on elephant sized deals in the faster growing private sectors. Additionally, there are fewer independent consultants/integrators for public sector software, so public sector software providers must have inhouse consulting forces. This makes it less attractive for the larger ERP players who prefer to leverage outside integrators like Accenture, etc. There is only one other nationally focused software vendor with a primary focus on the public sector.
4. **Shareholder Orientation:** In the period 2010 -2019, Tyler grew annual revenues by 16%, EPS by 21 %, and free cash flow by 23%. Management has repurchased over 45% of the company's stock since 2002, as well as consistently making intelligent acquisitions throughout the same period.

Finally, there are few activities more satisfying than doing something you enjoy doing...for a living.

As investors, we are constantly reading, thinking, researching, forming hypotheses, challenging them, and discussing investment ideas. It is intellectually fulfilling and engaging. We are lucky people. We look forward daily to managing our investors' money and doing what we love.

Please feel free contact us with any questions.

Aamer Khan

Co-founder

aamer.khan@qualivian.com

617-977-6102

www.qualivian.com

Cyril Malak

Co-founder

cyril.malak@qualivian.com

617-977-6101

www.qualivian.com

Appendix 1: Qualivian Focus Fund Quarterly Performance Table

	A QFF Gross Returns	B QFF Net Returns ⁽¹⁾	C S&P 500 TR Index ⁽²⁾	Difference with S&P 500 Index	
				A-C Gross	B-C Net
Q1 2018	5.4%	5.3%	-0.8%	6.2%	6.0%
Q2 2018	4.2%	4.1%	3.4%	0.8%	0.6%
Q3 2018	5.6%	5.5%	7.7%	-2.1%	-2.2%
Q4 2018	-14.6%	-14.8%	-13.5%	-1.1%	-1.3%
2018	-0.9%	-1.5%	-4.4%	3.5%	2.9%
Q1 2019	17.7%	17.5%	13.6%	4.0%	3.9%
Q2 2019	5.3%	5.2%	4.3%	1.0%	0.9%
Q3 2019	2.4%	2.2%	1.7%	0.7%	0.5%
Q4 2019	10.5%	10.3%	9.1%	1.4%	1.3%
2019	40.2%	39.4%	31.5%	8.7%	7.9%
ITD ⁽³⁾	35.0%	33.3%	26.3%	8.7%	6.9%

⁽¹⁾ As of November 2019, we began calculating Fund net performance reflecting new proposed Founders Class share terms of gross performance less a tiered management fee (75bps for first \$20M, 65bps for next \$20M, and 50bps for anything above \$40M) and no performance fee. The scenario above reflects a \$50M Founders Class investment. We have recast all the historical Net performance data to reflect these new assumptions. Prior to November 2019, our Net performance numbers reflected the terms of our Class A Shares, which have different terms (1% management fee and 15% performance fee over the spread to the S&P 500 returns), resulting in different net performance than shown above.

⁽²⁾ S&P 500 Total Return Index which includes reinvested dividends.

⁽³⁾ ITD = Inception-to-date and represents the time period from Dec. 14, 2017 through Dec. 31, 2019.

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