HAYDEN CAPITAL

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Dear Partners and Friends,

In the second quarter of 2016, the US stock market valuations continued to rise, only briefly interrupted by a sharp dip after Brexit. For all the hoopla surrounding the vote, the market reaction following it has been surprising. During the first two trading days post-Brexit, the S&P 500 declined over 5%. Many companies with significant exposure to the UK and Europe fared much worse, in what seemed to be a "sell first, ask questions later" strategy. This knee-jerk reaction was followed by an equally surprising 8% rise in the following weeks, in what can be described as a "buy first, ask questions later" reversal.

We continue to be positioned defensively during this volatile, extended bull-market period. We would rather miss the last 10% of gains of this market cycle, rather than risk our investors' capital to an (in our view) equally likely risk of a 30% decline. Until we discover a crystal ball that can accurately predict when this will occur, we feel more comfortable holding cash and waiting patiently. In the meantime, we remain steadfast to our values and continue to look for quality growing companies, reinvesting capital at high rates of return.

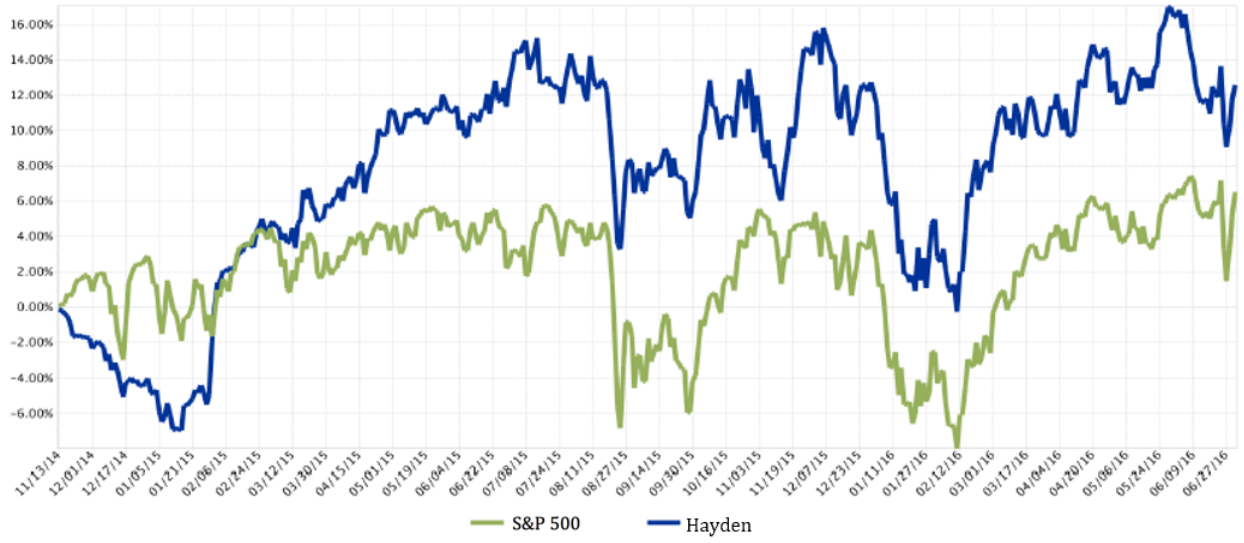
The downside volatility gave us an opportunity to purchase small positions in a couple businesses that we had been following, but were previously valued too highly. Alas, the decline was too short and valuations did not get compelling enough for us to make these full positions. We hope to add onto these names over next few quarters, when the opportunity presents itself.

Over the second quarter of 2016, your assets at Hayden Capital appreciated 1.23% compared to a 2.46% gain in the S&P 500. Our cash balance rose throughout the period, and ended the quarter at 28%.

Time Period	Hayden (Net)[1]	S&P 500	Relative Performance[2]	Avg. Cash %
4th Quarter[3]	(4.92%)	1.33%	(6.25%)	55.22%
2014	**(4.92%)**	**1.33%**	**(6.25%)**	**55.22%**
1st Quarter	11.16%	0.88%	+10.28%	37.79%
2nd Quarter	6.70%	0.21%	+6.49%	23.32%
3rd Quarter	(6.00%)	(6.42%)	+0.42%	23.92%
4th Quarter	5.14%	7.03%	(1.89%)	20.34%
2015	**17.23%**	**1.25%**	**+15.98%**	**26.31%**
1st Quarter	(0.23%)	1.33%	(1.56%)	22.53%
2nd Quarter	1.23%	2.46%	(1.23%)	27.64%
2016 YTD	**1.00%**	**3.82%**	**(2.82%)**	**25.11%**
Total Return	**12.57%**	**6.51%**	**+6.06%**	**28.33%**
Annualized	**7.52%**	**3.94%**	**+3.58%**	**-**

[1] Hayden Capital returns are net of actual fees. Individual client performance may differ based on fee schedule and date of funding.
[2] Relative performance compared to S&P 500 (Total Return).
[3] Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the S&P 500 reflects performance beginning on this date.

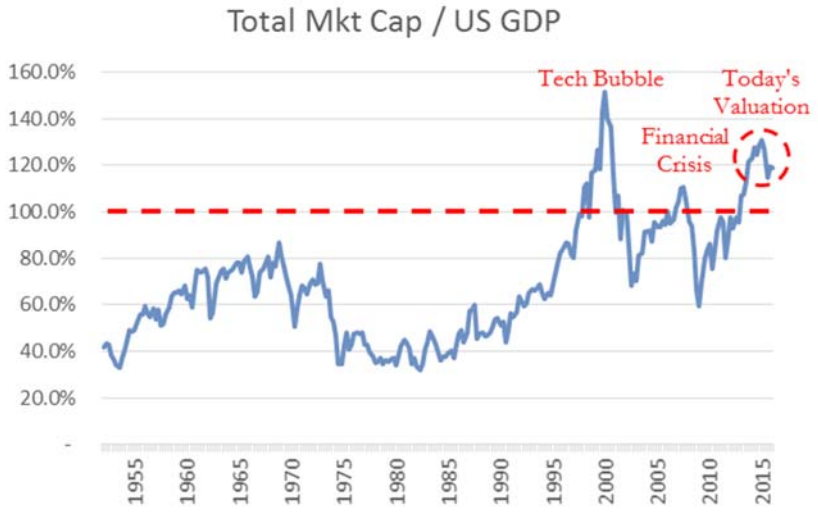
Since Inception



State of the Markets

As fundamental value-oriented investors, we don't attempt to predict macro factors that may cause moves in the broader indices. However, this does not mean we do not recognize when prices are expensive. One of the measures we follow is the total market capitalization of US companies divided by total GDP, which is similar to a "P/E" ratio for the country. Levels above 100% are generally considered expensive, with today's level of 123% being one of the highest in the last 50 years. As investors can see by the chart, the only times the study had prior crossed the 100% mark was the Tech Bubble and the Financial Crisis (neither of which turned out well for investors), indicating a worrying trend.

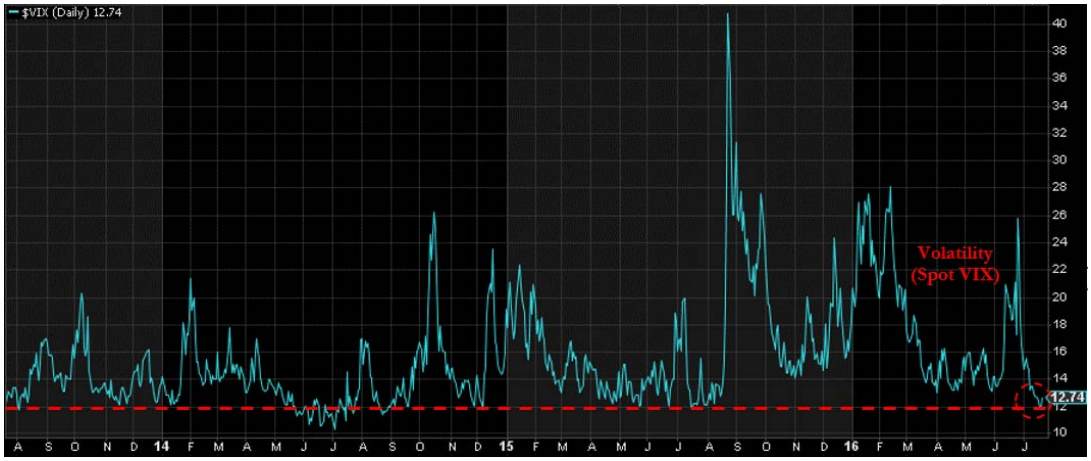
"We may never know where we're going, but we'd better have a good idea where we are."
– Howard Marks, Oaktree Capital Management



What worries us even further is that many of today's largest companies (Uber, Airbnb, etc.) have chosen to remain private, meaning their market capitalizations are not reflected in the above chart. As such, the current peak we see is *likely understated* compared to prior peaks. We've started to see some weakness in private valuations earlier this year, and our contacts who invest in the private markets are confirming that funding has been drying up. We don't know if this is just a temporary hiccup or an indication of something larger. Either way, today's environment doesn't make us very comfortable.

U.S. Stock Market vs. Global Indices

Volatility (Spot VIX)



Additionally, the S&P 500 is hitting all-time highs while the rest of world is going in the opposite direction. Europe is down 22% from its highs; Japan is down 20%; and China is down 41%[4]. It seems as if the U.S. is the last man standing; especially in a world increasingly facing risks of deflation, excessive

[4] We use the Euro Stoxx 50 Index as a proxy for European market performance. The Nikkei 225 Index and the Shanghai Stock Exchange Composite Index are used for Japan and China, respectively.

credit, and the crazy notion that is negative rates. If anyone would like us to hold onto your hard earned money for the next 10 years *and* pay us to do so, please give us a call.

On top of this, the market doesn't seem to care. Expected volatility, as measured by the VIX, is near its multi-year lows. The market has quickly forgotten all the Brexit and Eurozone related fears in just a few short weeks. S&P 500 profits have remained flat in the last three years, while returns have been fueled by multiple expansion, driven by a declining rate environment. In this market, we believe the smartest decision is to exercise caution and focus on protecting our capital.

This isn't to say the market will fall immediately or that we have any ability to predict when. Traders may bid up the markets over the next few months or year, and we will run the risk of looking like fools in the meantime. However, this is something we're comfortable living with. We would rather miss squeezing the last drops of returns out the market, than to be caught off-guard when it eventually turns. To create differentiated returns, our course of action must be different from the majority. So long as market valuations continue to increase in the near future, we expect our net exposure to come down as we build our cash position and/or begin actively utilizing market hedges.

Portfolio Updates

Against this backdrop, we have still managed to find a couple opportunities that we believe the market has overlooked and will appreciate on an absolute basis.

Baidu (BIDU): We continued to add to our BIDU position this quarter. In April, a 21 year-old Chinese student died after spending $30K on ineffective cancer treatments, which he found through Baidu's search engine. In the weeks prior, he had blamed Baidu for not clearly labeling the promoted link, which affected his decision in choosing the military hospital in which he sought treatment. This story became widely popular on the internet, and attracted the attention of regulators. After an expedited investigation, regulators instituted new rules to clearly label advertisements, consider credibility when deciding which search results to promote, tax sponsored results as advertisements, and limit the number of paid results per search.

Despite the media attention, we believe these new regulations are actually good for BIDU's business, and will not have a long-term impact. The new regulations are an industry standard, which other competitors must follow as well, and doesn't put BIDU at a competitive disadvantage. In fact, we believe these regulations may actually help BIDU's business over the long run, as it will have a disproportionate negative impact on smaller players, who are not well equipped to handle the lower ads per page and higher compliance costs.

Looking at the bigger picture, online advertising is still a nascent business in China, with a long growth runway (please see our 2016 Q1 letter for more details on the broader thesis). The majority of small and medium sized businesses are still not advertising online. Due to the fixed costs of running an ad campaign, it only makes economic sense for these small and medium size businesses to advertise on the platform with the largest audience pool (BIDU has 80% market share).

Another issue that has been pressuring the stock, is that BIDU has been spending on their Online-to-Offline (O2O) business, which includes Waimai (take-out food delivery), Ctrip / Qunar (travel booking), and Nuomi (coupon site similar to Groupon). So far, these initiatives have eaten into profits. The core search business is making RMB 25BN, however the losses from the O2O initiatives (in addition to content costs from iQiYi) bring consolidated operating profits to RMB 11BN. As such, it seems the market is giving no value to the BIDU's O2O segment, believing that it will lose money at the current run-rate forever. We take the opposite view, and expect these businesses in aggregate to be (hugely) profitable in the future.

For example, the sale of Qunar to Ctrip last year, in exchange for a 25% stake, created a near monopoly position for travel bookings in China, and gives BIDU valuable access to travel data for its search platform. This is just one sample of the value creation happening in O2O. Meanwhile, the investments in Online-to-Offline are obstructing the superior economics of the search business, which offers an opportunity for investors willing to take a longer-term view.

If BIDU were to stop spending on these new initiatives (or merely break-even), we believe the core search business would be trading at 10x Free Cash Flow (10% yield). This strikes us as an extraordinarily cheap valuation for a virtual monopoly at 80% of total search market share, with a strong demographic tailwind, and projected to grow revenues 20% annually.

We've been taking advantage of the recent volatility and adding to our position, most recently below $160. The market will forget the short-term noise around the medical advertising controversy, and the O2O will get closer to profitability in time. When this happens, we believe the market will start to recognize the true value in the Baidu.

Credit Acceptance (CACC): Credit Acceptance is one of our oldest positions, among one of the first purchases when Hayden was founded. For nearly two years, we have patiently waited as the subprime auto sector competition intensified, underwriting standards became ever looser, and the industry reached a cyclical peak. We believe these good times are finally ending… and this is great news for CACC.

CACC has been preparing for this industry rationalization for a while. Over the last few years, thousands of new entrants, flooded with cheap debt, have pressured loan pricing to irrational levels. These competitors didn't care about adequately pricing in the long-term risk, as their intention was to quickly securitize these loans and sell them off to the public markets (sound familiar?).

In this madness, CACC has chosen to maintain their underwriting standards. This resulted in them doing fewer loans per dealer, which they compensated for by doubling their salesforce and expanding the total number of dealer relationships. Instead of underwriting 50 loans per dealer, they shifted to "cherry-picking" the best 30 loans per dealer, but doing business with twice as many dealers.

When the cycle eventually turns, capital markets will be the first to dry up. The result is higher funding costs and limited capital for new loans. Many of the new lenders who are dependent upon the capital markets will be forced out of business. In fact, we're already starting to see this happen. Over the last year, ABS rates have increased 40%, to ~3.5%, which has put pressure on these players. Santander, Ally, and many others are scaling back their subprime business, and several others (including Go Financial) are going out of business altogether. We believe this is just the beginning.

We expect CACC to take share from these lenders, as capital leaves the industry. With little competition, they will easily be able to increase the number of loans they do per dealer, across twice as many dealers. Foreseeing that capital markets will likely be closed and/or expensive during this period of opportunity, CACC has been building up their capital. They currently have $800M in untapped revolvers, which they recently extended. We project that combined with the principal from existing loans they'll receive over the next year, CACC will have over $1.5BN to deploy (or close to 50% of their existing loan book). Given the lower competition, we expect these new loans to have better unit economics and returns on capital of 15-17%.

For comparison, during the last cycle downturn, CACC was able to double the amount of capital deployed (from $700M in 2007 to $1.4BN in 2011), at ROIC's as high as 19%. Earnings per share also increased 400%, from $1.76 to $7.07, during this time period. While we don't expect as drastic of results this time around (partly because CACC is of a much larger size now), we believe this is illustrative of CACC's earnings power.

At 10x forward earnings, run by a management team with substantial "skin in the game" (50% ownership), an exceptional history of capital allocation, and an earnings engine, which we believe, is just at

the start of a multi-year growth period, we cannot be more excited about this company. If market forces allow, we would be happy to increase our (already substantial) position in Credit Acceptance.

Well Fargo Warrants (WFC): We exited this position, as it became clear to us that the possibility of rate hikes this year have been significantly diminished. We had been trimming the position over the course of May and June, and Brexit was the nail in the coffin. It's unlikely that with negative rates in much of the world, that the Federal Reserve will have much ability to raise interest rates without affecting the fragile state of the economy or without resulting in a strengthened dollar. We still like the business, and believe that WFC will continue to capture deposit growth at a high single-digit rate, and achieve normalized earnings of over $5 per share within the next few years. However, we found better uses for the capital, which offered more attractive risk-reward opportunities. The position had accounted for 4% of our portfolio, on which we suffered a small loss.

New Positions: We also initiated two small positions in the last few weeks. As we are still in the process of building these positions, and waiting for better valuations to do so, we will decline from discussing these additions. It is our intention to convey our in-depth thesis in the future once we are able to establish full positions.

Conclusion

We continue to be very excited about the prospects for our firm. In order to create differentiated results from the market, we must invest and think differently as well. Sometimes this will create short-term volatility. However, we believe the superior results of our process will be worth these short-lived fluctuations.

Additionally, we continue to hold a large cash reserve and look for good opportunities to put that cash to work. We know those opportunities are coming, we just don't know when.

Lastly, we'd like to thank our investors for their continued support and trust for managing their hard-earned assets. We are also open to new investors and introductions to potential investors who may appreciate our investment philosophy.

As always, please feel free to call or visit the office if you'd like to chat.

Sincerely,

Fred Liu
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