HAYDEN CAPITAL

79 Madison Ave, 2nd Floor
New York, NY. 10016
www.haydencapital.com

October 23, 2016

Dear Partners and Friends,

It's nice to finally get a break. It seems every quarter has had some variety of tumultuous event recently… Chinese currency devaluation, premature Federal Reserve rate hikes, China growth scares again, and Brexit. However, this past quarter was eerily quiet for the first time in a while. After a sharp 8% recovery in the three weeks following Brexit, the market remained range-bound. Volatility as measured by the VIX index reached its lowest levels of the year during this period.

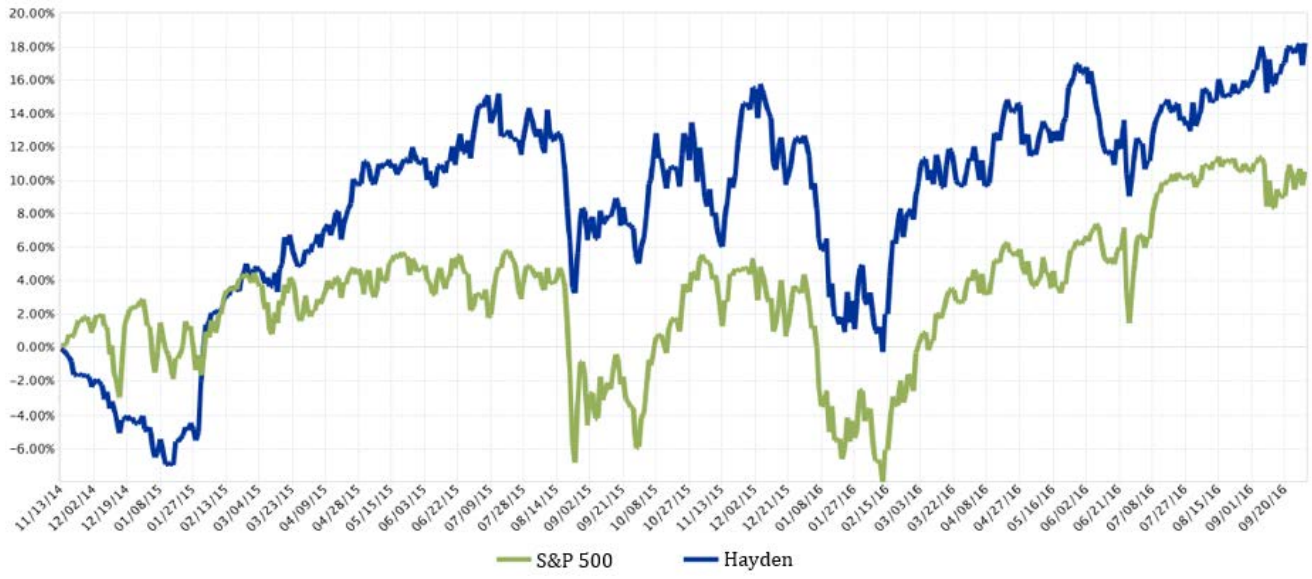
The performance of the S&P 500 this quarter may make one believe that all is well in the world. However, what may seem calm and serene on top, masks the turbulence and rip currents lying below.

Going forward, there are plenty of issues to be worried about. The slowest economic recovery in decades, the highly watched reality-tv that is the US Presidential Election, low inflation, rising government debt, and over a third of global government bonds returning *negative* yields (investors paying governments for the privilege of holding their hard earned cash) are all concerns that could cause uncertainty and increased volatility in the near future.

Time Period	Hayden (Net)[1]	S&P 500	Relative Performance[2]	Avg. Cash Exposure[3]
4th Quarter[4]	(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%
3rd Quarter	5.04%	3.78%	+1.26%	32.60%
2016 YTD	**6.09%**	**7.74%**	**(1.65%)**	**27.64%**
Total Return	**18.25%**	**10.54%**	**+7.71%**	**28.91%**
Annualized	**9.31%**	**5.47%**	**+3.84%**	**-**

[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] Includes Cash and Inverse S&P 500 ETF, which allows us to decrease our long exposure without paying taxes on profitable positions.
[4] 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



I believe markets have yet to adequately price these events into the valuations. Until this occurs, we plan to tread carefully and select only the most high quality investments for our portfolios.

This cautiousness led me to increase our cash exposure during the quarter, to end the period at 35%. I'm happy to report that despite this "cash drag", our portfolio managed to beat the S&P 500 by +1.26%. Over the third quarter of 2016, your assets at Hayden Capital appreciated 5.04% compared to a 3.78% gain in the S&P 500.

Some investors have questioned why I hold so much cash, and it's true that if our portfolio were fully invested this year, we would have produced returns of 8.41% versus our actual return of 6.09%. Thus surpassing the market's YTD return of 7.74%. This implies that my decision to hold cash has cost us 2.32% of performance, however, this is a trade off I am more than happy to make. The value of holding cash lies in its "optionality" value, which allows us to purchase cheap securities during market uncertainty without needing to sell existing positions (which would have likely become cheap themselves in a market sell-off). I believe at this point in the cycle, this "option" value is worth more to our investors than being fully invested.

I am not bullish on the S&P 500, but I am bullish on our companies. I am very satisfied with how our portfolio companies have performed year-to-date, and believe this will continue going forward. As the below exhibit shows, our equity portfolio is much superior to that of the broader S&P 500 index. Not only are our portfolio companies less expensive than the market, but in fact I expect it to grow 54% faster! More importantly, the companies are growing *smartly* through capital allocation, and reinvesting back in their business at +15% returns.

Hayden Capital Portfolio vs. S&P 500

Based on FY 2017 Estimates

	Growth Y/Y	EV / EBIT	P/E
Hayden Capital	16.6%	11.5x	14.8x
S&P 500	10.8%	11.5x	16.5x
Difference %	**53.5%**	**(0.6)%**	**(10.3)%**

Source: Hayden Capital; Company Data; Yardeni Research

Additionally with interest rates at historic lows, it's unlikely that the market's P/E ratio will expand much further. This means that future gains will need to come from growth in the "E" portion of the equation. I believe our portfolio, with a growth rate 54% higher than that of the market (and cheaper valuation to boot), will have a great chance of outperforming going forward.

Too Much Of A Good Thing

Recently, I came across two articles titled "The Rise of the 'Do-Nothing' Investor" and "The Dying Business of Picking Stocks" in the Wall Street Journal. In the articles, it talked about the rise of passive mutual funds and ETFs, and how it is changing the investment landscape. Granted, this is not ground-breaking news; the debate between passive and active investing has been going on for at least a decade.

But being the contrarian that I am, my brain naturally thought to this cover. In 1979, Businessweek infamously declared "The Death of Equities", after multiple years of low returns and predicted it would remain that way going forward. They couldn't have picked worse timing. In the next ten years, the market *tripled* and proved them wrong. It is too often the case that when a topic becomes so popular that it starts gracing magazine covers, the trend is at an end and you should be doing the exact opposite (maybe I should start ordering Businessweek…).

The Death of Equties

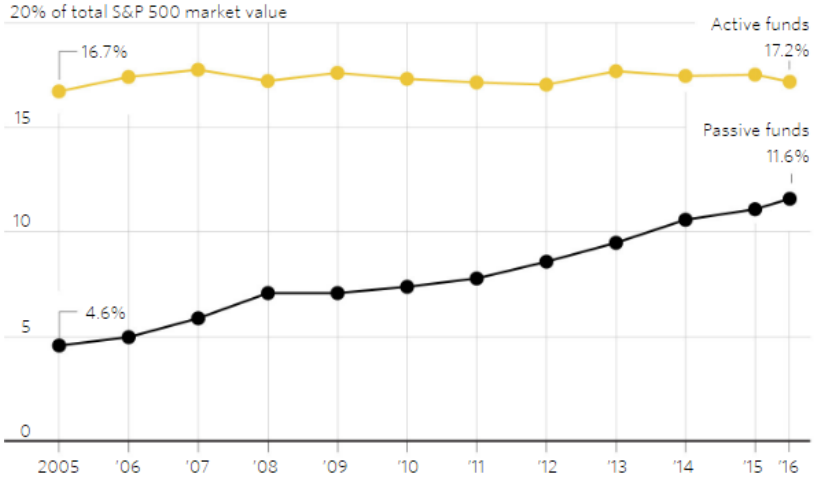
Businessweek 1979 Cover

Source: Businessweek; Investing Caffeine

In the last 20 years, the amount of money invested in passive products have risen 7,270%, to over $4 Trillion today. Passive funds now own 11.6% of S&P 500 companies, compared to 4.6% only eleven years ago. Now there is a good reason for why investors have flocked to these products. Fees are low, they're easy to buy and sell, and investors are able to view the value of their funds on a per second basis. The fact that many traditional mutual funds have underperformed their benchmarks, partly due to their inherently flawed structure, has only added fuel to the fire (we've touched upon this in previous letters).

Growing Market Share of Index Funds

Percentage of S&P 500 companies owned by Index Funds

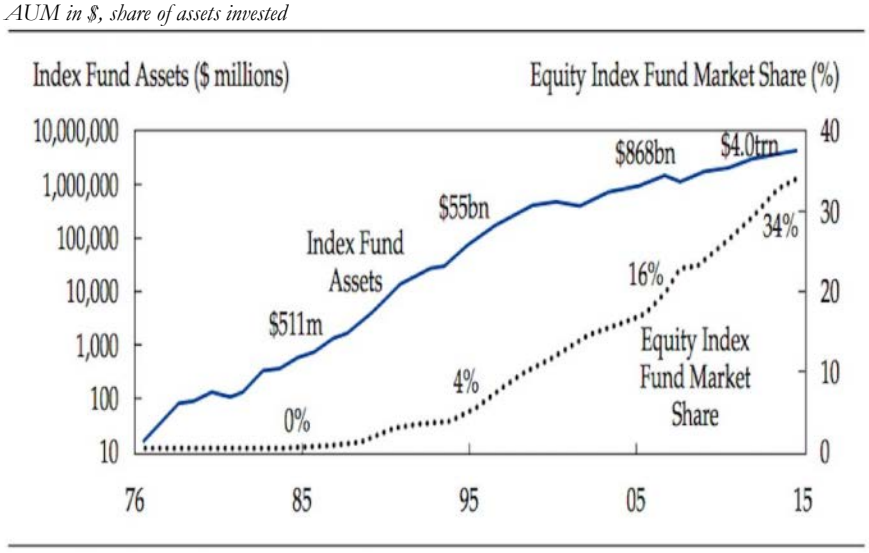


Source: Wall Street Journal

Passive funds certainly deserve a place in one's portfolio, and I have encouraged some of our own investors to do exactly that. However like any asset class, whether actively managed or not, it does carry risk. And certainly placing an entire portfolio in passively managed products likely isn't prudent. You can have too much of a good thing.

Growth of Index Funds

AUM in $, share of assets invested



Source: Business Insider; Morningstar; Strategic Insight Simfund

The issue is that passive funds make up over 34% of discretionary assets today – a figure that continues to rise at an astronomical rate. If the trend continues, the majority of investable assets in the world will be passively invested in a little more than a decade.

The risk with this is that ETFs and other tracking products don't take into account the most important aspect of investing: valuation. In fact, it doesn't take into account anything except for how large a company is within the index.

It's easiest to see the problem with this, when taken to the extreme. In a world without active investors, the weighting of companies within an index would never change. Even if the largest company in the index were a cancer-causing, perpetual money-losing widget maker, with factories that emit radiation. In a completely passive world, such a toxic company would continue to attract greater amounts of capital than more beneficial endeavors.

It's hard to miss the irony here. In this new universe, the original rational for passive investing – that markets are efficient so trying to beat it is useless – would fail. Too many followers of passive investing would in fact cause its own demise. Under this scenario, any investor who chooses to spend even a few hours reading an annual report would handily outperform the market. Additionally, companies that lie outside the indexes would provide valuable hunting ground for enterprising investors. Investors in ETFs that track the popular S&P 500 index, would only be invested in 500 stocks. There are 3,700 stocks publicly listed in the United States, and many thousands more traded over-the-counter, many of which would be neglected and without capital[5]. Surely, those brave enough to venture outside of those 500 names would find great opportunity and profits.

We haven't reached this extreme yet. However if the trends in passive investing continue at their current pace, we will be close within the next decade or two. At that point, I suspect active investing will be the new "fad" in investing, just as passive investing is today. As so often happens in the markets, the pendulum will start swinging the other way. Similar to dieting, over concentration in one food group or investment vehicle can lead to unwanted consequences, no matter how sound the original rational. The key to both a healthy diet and financial portfolio is balance.

Portfolio Updates

Baidu (BIDU): I continued to build our position in BIDU, and have increased our position by 36% in the third quarter. The majority of these shares were purchased below $160, after the stock touched upon this price level several times in July. As of quarter-end, we have realized a 16% gain on these purchases. However, as described in our letter last quarter, I believe there is still plenty of value left that the market has yet to recognize. The big gains are still ahead, and would kindly refer you to look at our 2016 Q2 Investor Letter for more details on my thesis.

Credit Acceptance (CACC): Credit Acceptance is one of our oldest positions, which I had an opportunity to add to in the third quarter. Over the last two years, I have been surprised by the stubborn cheapness and lack of market enthusiasm for the name (which we're not complaining about).

Since our initial purchase for Hayden Capital accounts ~$140, the entire rise in price has been driven fundamentals, rather than an expansion in market multiples. In November of 2014, I expected the company to earn ~$12 per share (which they achieved), and were willing to pay an 11.6x P/E multiple as a result. Over the past two years, Credit Acceptance has grown earnings at a rate of 15.4% per year. This year, the business is poised to earn ~$16 per share. At the same multiple as our initial purchase, this would imply a price of $186. Shares have been trading between $183 - $190 in recent weeks.

I firmly believe the business is superior to your average company in the S&P 500. The founder still owns 50% of the business, compared to the average CEO who owns less than 6%.[6] This dynamic highly incentivizes management to align their interests with common shareholders. Additionally, I estimate the

[5] Bloomberg, "Where Have All The Publicly Traded Companies Gone" (LINK)
[6] NYU Stern, "Insider and Institutional Holdings by Sector (US)" (LINK)

company is able to consistently earn 15 – 17% returns on invested capital, which is far superior to that of the average company. This means that for every $1 management invests back into the company, investors can expect to get a 15 – 17% yearly return.

Given these superior dynamics, it's surprising that CACC's P/E multiple has not been bid up, while the S&P 500's P/E ratio has risen 32% in the same time period (from 18.5x in November 2014 to 24.6x today). I think this is mainly due to the market's misperception of Credit Acceptance as a run-of-the-mill subprime auto lender, an industry which they fear is at the peak of its earnings cycle. I disagree, and have proven that Credit Acceptance is different than the pack, and believe they will actually take market share and *increase* earnings when the rest of the industry contracts. In fact, I believe that Credit Acceptance is at an inflection point, and is poised to grow earnings even *faster* over the next few years.

Lastly, another data point that gives me comfort in my valuation, is that the company itself has been buying back its shares at similar multiples. In recent years, Credit Acceptance has completed a tender offer at $125.54 in October 2014 (10.5x P/E multiple), and repurchased 464K shares at $184.20 in November & December 2015 (12.8x P/E multiple). Credit Acceptance has publicly stated (and proved through their actions) that they will only opportunistically repurchase shares when doing so provides a better return on investment than using the capital to make more loans (which yield double-digit returns). As such, I am comfortable that purchasing shares at 11.6x multiples will yield us similarly satisfactory results.

For these reasons, I believe the company deserves a higher than market multiple, not less. I added to the position in July, when the stock traded down 12% in the weeks before they announced third quarter earnings. It seemed the market was afraid the company would report poor results, while my analysis indicated the opposite. Our purchases were made between $180 - $184, after which the company reported EPS growth of 17% y/y, and shares hit a high of $210 as a result. I will wait for these types of opportunities in the future, and am happy to allocate additional capital to the investment when shares reach the valuation described.

My Credit Acceptance thesis is discussed further in depth in our Q2 2016 Investor Letter, which I recommend reading. I also anticipate putting out a detailed research piece on the company over the next several weeks.

Cimpress (CMPR): I trimmed 15% of our Cimpress position at an average price of $99.29, after the stock rose in the third quarter. I used the cash to build up other positions, where I felt the valuation was more attractive. Since our initial purchase a year ago, we have made a 51% return in the name, and the thesis I laid out in my Cimpress Presentation in April remains on track. I still expect the company to compound at its high double-digit reinvestment rate (the company is reinvesting almost all cash flow back into the firm); however the odds of a further multiple expansion "kicker" are lower at these valuations.

New Positions: I added one new position in the third quarter. Similar to our two positions established in the second quarter, the investment remains small as I wait for better valuations to establish full positions. While I am in the process of adding to these investments, I will refrain from discussing them. I intend to convey our thesis once we are able to establish our full positions.

Conclusion

Lastly, on the operational front, I will be in California from December 2 – 18th. I would love to meet with current and potential investors during that time. If you know of anyone in the area you think may be a good fit or would simply like to learn more about our investment philosophy, please have them reach out!

As always, I'd like to thank our investors for their continued support and trust for managing their hard-earned assets. Please feel free to reach out if there is anything I may help with. I am always happy to chat via email, phone, or over a cup of coffee.

Sincerely,

Fred Liu
Managing Partner
fred.liu@haydencapital.com

The information and statistical data contained herein have been obtained from sources, which we believe to be reliable, but in no way are warranted by us to accuracy or completeness. We do not undertake to advise you as to any change in figures or our views. This is not a solicitation of any order to buy or sell. We, any officer, or any member of their families, may have a position in and may from time to time purchase or sell any of the above mentioned or related securities. Past results are no guarantee of future results.

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact.

Hayden Capital is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy, investment process, stock selection methodology and investor temperament. Our views and opinions include "forward-looking statements" which may or may not be accurate over the long term. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security.