



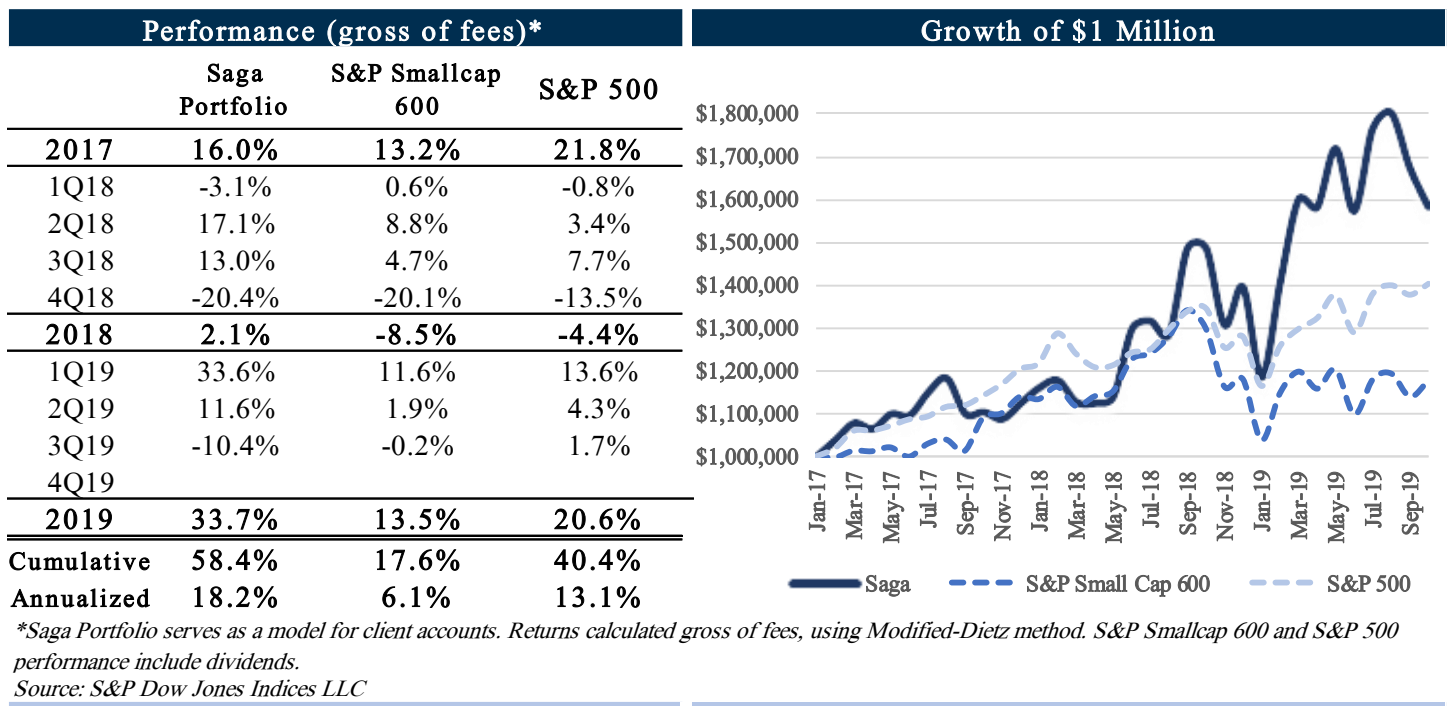
QUARTERLY REPORT

THIRD QUARTER 2019

3Q19 Results

During the third quarter of 2019, the Saga Portfolio (“the Portfolio”) decreased 10.4% gross of fees. This compares to the overall decrease, including dividends, for the S&P Smallcap 600 Index of 0.2% and increase for the S&P 500 Index of 1.7%.

The cumulative return since inception on January 1, 2017 for the Saga Portfolio is 58.4% gross of fees compared to the S&P Smallcap 600 Index and the S&P 500 Index of 17.6% and 40.4%, respectively. The compounded annual return since inception for the Saga Portfolio is 18.2% gross of fees compared to the S&P Smallcap 600 and S&P 500’s respective 6.1% and 13.1%.



Annual Meeting

We held our 2nd annual investor meeting this past August. It was great to have an opportunity to see many of our investors face to face. These annual meetings, along with our investor letters, help us manage the Portfolio in as transparent a way as possible. Mike and I want to lay out in simple terms how we think, manage the Portfolio, and the reasoning behind the Portfolio’s investments. It’s important for our investors to understand where their money is and why it is there. We believe everyone who was able to attend enjoyed the event and we encourage those who could not make it to stop by next year!

Market Outlook

There is a section in the book *Naked Economics* by Charles Wheelan that looked like a similar answer to the one we give when anyone asks what we think the market is going to do:

“Where will the Dow close tomorrow? I have no clue. Where will it be next year? I don’t know. Where will it be in five years? Probably higher than it is today, but that’s no sure thing. Where will it be in twenty-five years? Significantly higher than it is today; I’m reasonably certain of it.”

There is an enormous amount of money around the world that is managed by an electronic herd of people who think that a decision needs to be made on everything in their portfolio every single day. Saga Partners’ expertise is not in trying to time when to be in or out of the market based on factors outside our control: it is in evaluating individual companies.

We understand the innate worries and seemingly heightened level of uncertainty in the global economy. There are growing government debts and fiscal deficits, trade tensions with China, ongoing central bank stimulus to boost economic growth while market forecasters claim we are “due” for a correction. However, when is there not a heightened sense of uncertainty in the markets? And when markets do inevitably panic again, as they did in the fourth quarter of last year, will investors then overcome their fears and say now is the right time to invest? Or will they wait until things calm down and become less uncertain?

We are certain that another recession will happen sometime in the future, but we do not know when it will happen, how long it will last, or how extreme it will be. We do not even know how the market will react going into and coming out of it. We do know during 2008 following the Lehman Brothers bankruptcy and subsequent financial meltdown, the outlook at the market lows was far from certain. We prefer to keep our heads down, ignore the noise, and simply look for the best opportunities we can find given the information we have today. As we’ve noted before, more money has been lost waiting for corrections or trying to anticipate them than has been lost in the corrections themselves.

Update on Benchmarks

We have a few minor updates, the first being on the referenced benchmark. You may notice we are now using the S&P Smallcap 600 index as a small cap benchmark instead of the more commonly referenced Russell 2000 used for small cap portfolios. Last month FTSE Russell, the company that owns and manages the Russell 2000, threatened legal action if we did not start paying a significant annual payment for the right to reference the Russell 2000 returns. While we prefer consistency, it was not a difficult decision to find a cheaper alternative. It is encouraging

to know the readership of these letters has grown outside our core investor base, even if some threaten to sue us.

It should be good to know we have not picked a new benchmark that makes our relative results stronger. The S&P Smallcap 600 has slightly outperformed the Russell 2000 since the Saga Portfolio started on January 1, 2017. Its annualized return has been 6.1% vs. the Russell 2000's 5.7%.

Discussing benchmarks, Saga Partners' goal is to beat the general market over the long-term. In doing so, we have referenced the S&P 500 as well as the Russell 2000 Index (S&P Smallcap 600 going forward). There really isn't a good benchmark to compare relative performance to a fairly concentrated, general public equity investment portfolio that has few overlapping investments with any benchmarks. We use the S&P 500 because it is a widely referenced and easily investable index for a passive investor and it has proven to be a very difficult yardstick to beat, with 90-95% of actively managed mutual funds underperforming the index over the long-term.

We also like to reference a small cap benchmark because historically the Saga Portfolio has largely been composed of small to mid-cap stocks (companies with a market cap less than \$10 billion). The Saga Portfolio's performance will likely be slightly more correlated to a small cap index over the short term. This does not mean the Portfolio will always be composed of small and mid-cap companies, but this is where we have found some of the best opportunities and likely expect to find opportunities in the foreseeable future.

Below is a breakout of the Saga Portfolio, S&P Smallcap 600, and S&P 500 index by market cap as of the end of last quarter.

	Market Cap	Saga	S&P Smallcap 600	S&P 500
Small-Cap	<\$2B	32%	57%	0%
Mid-Cap	\$2B - \$10B	52%	43%	2%
Large-Cap	\$10B+	11%	0%	98%
	Cash	5%	0%	0%
	Total	100%	100%	100%

Source: Saga Partners, Factset Research Systems

You may notice how small cap stocks/indices have generally underperformed the larger cap universe in recent years. Historically, over multi-decade periods, comparative results have been relatively similar. Some believe the divergence in performance could be due to the significant growth in passive investing as funds increasingly move into ETFs that are made up of larger indexed companies. Another reason may be the influence of big technology companies having a greater impact on aggregate large cap performance because of their ability to grow/scale to a greater degree. Perhaps it's a transient market aversion for smaller companies.

Whatever the reason may be, we do not know if there has been a permanent paradigm shift in favor of larger companies. Regardless of how any specific category of stocks performs, we are just trying to find the best opportunities available regardless of size and hope to outperform both indices overtime.

Management Fees and Portfolio Size

Another change is that we are now reporting the Saga Partners returns *gross* of fees instead of *net* of fees. At the end of the day, all that matters to an investor is the money they can take home and spend after paying all fees, therefore it's net results that matter. The reason for the change is because we have a few early investors that have a different fee rate than the 1.5% AUM we currently charge. Reporting gross returns provides a more consistent report for all parties and each investor can deduct/net out the quarterly fee that was charged to their account which is 0.375% (1.5%/4) of assets managed at the beginning of the period for most accounts. You can also check your brokerage statement and simply calculate the change in your balance from period to period to calculate your net returns.

Note that an individual's returns may vary depending on when they entered the Portfolio and the timing of any new contributions. We attempt to allocate each separately managed account as similarly as possible to the model portfolio.

It's important to understand any and all fees that you may be paying for any investment services. We've met with many individuals that do not even know what they are paying for the different investment funds they may be in since brokerage statements often make it difficult to know the actual dollars/fees being paid.

Investment managers are typically paid by either an assets under management (AUM) fee, a performance fee, or a combination of both. There is not necessarily any right fee structure, but there can definitely be a wrong fee structure. In their heyday, hedge funds historically charged a 2% AUM fee and 20% performance fee. As hedge fund performance has been lackluster over the past decade, a 1.5% AUM fee and a 15% performance fee have become more common. When Warren Buffett ran his investing partnership in the 1950s-1960s, his fee structure had no AUM fee and a 25% performance fee above a 6% hurdle. Unlike most hedge funds, Buffett only got paid if he performed.

Saga Partners only charges an assets under management fee and no performance fee. We like this structure because it is simple. We also have several non-accredited investors which can't be charged performance fees, therefore this structure provides a simple fee structure applied across the board.

A performance fee is calculated as a percentage of the investment returns. Its purpose is to incentivize investment managers to earn strong returns for the portfolio. While there can be some truth to that, when we look over the actual net results of the majority of hedge funds or mutual funds that charge performance fees, it is very rare to find funds that provide market beating returns net of fees throughout a full market cycle.

It actually doesn't matter how much money a portfolio manager charges *as long as they are able to beat their benchmark* by a wide enough margin over time *after fees are deducted*. Paying for strong outperformance makes sense but too often fees are excessive relative to the value a fund manager provides. The more commonly used performance fee structures make it very difficult and nearly impossible for a fund to outperform over time. Too often the portfolio manager makes a killing while their clients get lackluster results.

Below are four examples of different fee structures: 1) the typical hedge fund structure of 1.5% AUM and 15% performance fee, 2) 2.0% AUM and 20% performance fee, 3) the fee structure that Buffett used during his investment partnership, and 4) Saga Partners' 1.5% AUM and 0% performance fee.

Fee Structure	
1	Hedge Fund A 1.5% AUM, 15% Performance
2	Hedge Fund B 2.0% AUM, 20% Performance
3	Buffett Partnership 0.0% AUM, 25% Perf. over 6% Hurdle
4	Saga Partners 1.5% AUM, 0% Performance

Over the past 25 years, the S&P 500 provided a total compounded annual growth rate (CAGR) of 9.8%. Below is a chart showing the required gross return (before fees are charged) that would be required for the fund to simply match the S&P 500's performance after charging fees.

Hedge Fund A and B would have had to provide gross annual returns of 13.0% and 14.3% respectively to simply match the S&P 500's 9.8% CAGR. The Buffett Partnership structure would have had to provide 11.1% gross annual returns, and Saga Partners would have had to provide 11.3% gross annual returns.

0% Outperformance After Paying Fees

	Required Gross Returns	AUM Fee	Performance Fee	Total Fees	Portfolio Net Returns	Outperformance
1	13.0%	1.5%	1.7%	3.2%	9.8%	0.0%
2	14.3%	2.0%	2.5%	4.5%	9.8%	0.0%
3	11.1%	0.0%	1.3%	1.3%	9.8%	0.0%
4	11.3%	1.5%	0.0%	1.5%	9.8%	0.0%

Source: Saga Partners

Given all the time, effort, and resources put into managing an investment portfolio, hopefully investors in the portfolio would receive some outperformance or else they might as well simply invest into a low-cost index fund.

Assume you would like the fund to outperform the S&P 500 by at least 5% annually. Hedge Fund A and B would have had to provide gross annual returns of 18.9% and 20.5% respectively. The Buffett Partnership would have had to provide 17.7% gross annual returns and Saga Partners would have had to provide 16.3% gross annual returns. Note this does not include the taxes investors would have to pay along the way depending on the level of turnover of the strategy.

5% Outperformance After Paying Fees

	Required Gross Returns	AUM Fee	Performance Fee	Total Fees	Portfolio Net Returns	Outperformance
1	18.9%	1.5%	2.6%	4.1%	14.8%	5.0%
2	20.5%	2.0%	3.7%	5.7%	14.8%	5.0%
3	17.7%	0.0%	2.9%	2.9%	14.8%	5.0%
4	16.3%	1.5%	0.0%	1.5%	14.8%	5.0%

Source: Saga Partners

Outperforming the index by 5% is significant, providing over 200% greater value at the end of the 25-year period. However, to get that 5% outperformance a hedge fund with a standard fee structure would have had to earn ~20% gross returns. The number of funds that were able to earn greater than 20% gross returns over that period were few and far between and those that did are held up as investing prodigies. Investors paying these types of fees should understand that they are betting that the specific strategy will require Warren Buffett-like returns in order to earn a few points of “alpha.”

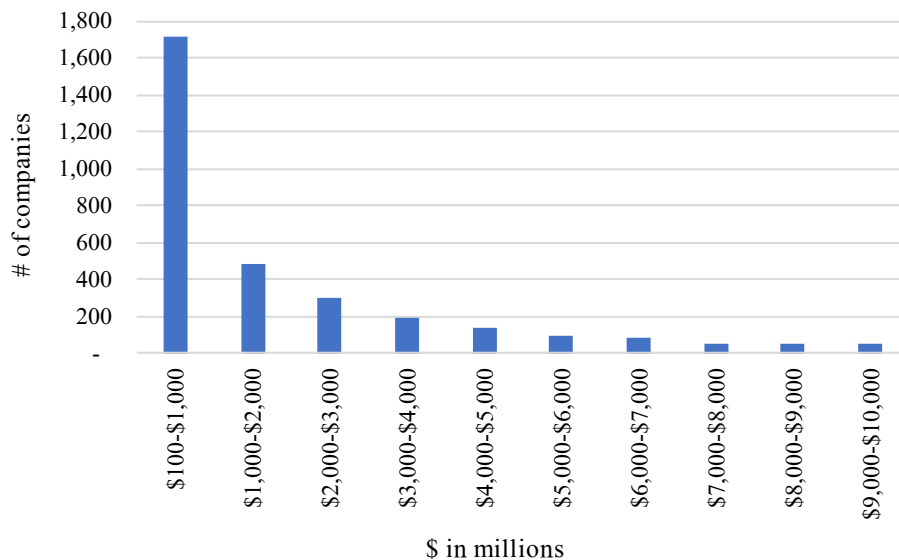
Based on our current fee structure, Saga Partners’ “hurdle rate” to provide outperformance is always 1.5% above the index returns. All outperformance above that goes straight into our investors’ pockets. It can be argued that only charging an AUM fee does not incentivize the portfolio manager to perform. It could also be argued that the manager is incentivized to grow assets under management with no consideration of how that could negatively impact performance since size eventually becomes an anchor on compounding. While Saga Partners is far from the point that size will start limiting investment opportunities, it is a question we have been asked by prospective investors and is important to consider as we think where we will be in 10, 20, and hopefully 30+ years down the road.

There is no question that size limits investment opportunities which inevitably impacts potential returns. That doesn’t mean you can’t find great investments in large caps (we are invested in one of the largest companies in the world), it just means that you have fewer opportunities to choose from as size becomes a limiting factor.

Just by looking at all publicly traded companies within the U.S., you can see that as you move up in market cap, the number of companies, therefore investment opportunities, become exponentially smaller.

Going by billion-dollar ranges, there are over 1,700 U.S. companies with a market cap between \$100 million - \$1 billion, nearly 500 companies between \$1 - \$2 billion, 300 companies between \$2 - \$3 billion, and the number continues to decline as you move up in market cap.

U.S. Publicly Traded Companies by Market Cap



Source: Saga Partners, Factset Research Systems

Many of the small to micro-cap companies do not meet our investing filters. We have found a lot of success investing in companies in the \$1 - \$10 billion market cap range. At this size/stage in many companies’ life cycle, they often have been able to express a strong competitive advantage and still have a long runway to grow. Note that ~30% of the Saga Portfolio was invested in companies with a market cap less than \$2 billion, with the smallest company having a ~\$400 million market cap at the end of the quarter.

Saga Partners is and will continue to be a tiny speck in the investment management world. While we are pretty far from the point that size might become a limiting factor, we will close to new investors way before we believe size could start hurting performance. We do not know what the investing landscape will look like at that time but we can use today’s world to back into rough numbers.

Assume we would like to continue to easily invest in companies with a \$1 billion market cap. If we do not want to take much more than a 5% ownership stake in the company, that would mean we could invest \$50 million in a \$1 billion company. If it was a 10% position in the Saga Portfolio, the portfolio size would be ~\$500 million assets under management. If \$500 million is the point

where size starts limiting some of our investing opportunities, we would want to close to new investors at a size even smaller, probably in the ~\$300 million range. Why is that? If you are able to compound \$300 million at a 15% rate, it would grow to \$600 million in 5 years, and in 10 years it would become \$1.2 billion. If a portfolio manager tells you they can invest \$1+ billion in the same way they can invest \$100 million, they are mistaken. You can see why compounding at high rates for long periods is very difficult to do—numbers become large very fast and size will weigh you down.

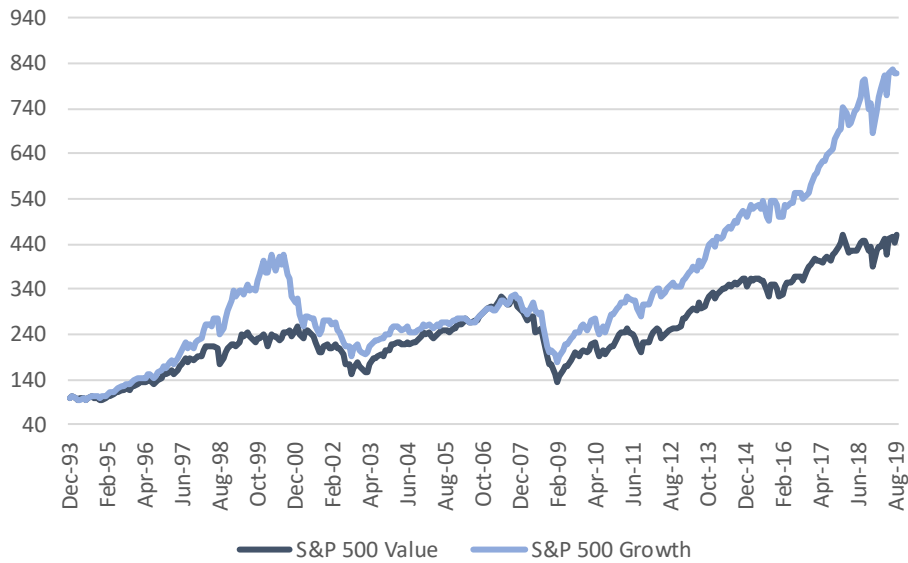
While the size of the Saga Portfolio has grown at a fast pace this past year (off a relatively small base) as a result of both performance and new funds entering the Portfolio, it is not our goal to become one of the largest investment funds in the world. It is also not our goal to maximize the potential fees that can be earned from managing it. We started the Saga Portfolio as a way to manage other people's money in the same way we had managed our own. Nearly all of our personal investable assets and much of our close family's investable assets are in the Saga Portfolio.

It is well-known there is a diminishing marginal utility of income and wealth. As income/wealth increases, individuals gain a correspondingly smaller increase in satisfaction and happiness. After one is able to afford a nice/safe place to live, eat the food they want to eat, vacation to the places they want to visit, and still save enough to ensure a secure future, the rest is just icing on the cake. We get much more joy from trying to understand businesses, solving market anomalies, and managing an investment portfolio in the way we think is best instead of trying to maximize potential fee income. Earning strong returns for our closest family, friends, and other investors who align with our philosophy and have entrusted us with their savings is more important to us than earning the next incremental dollar.

Is Value Investing Dead?

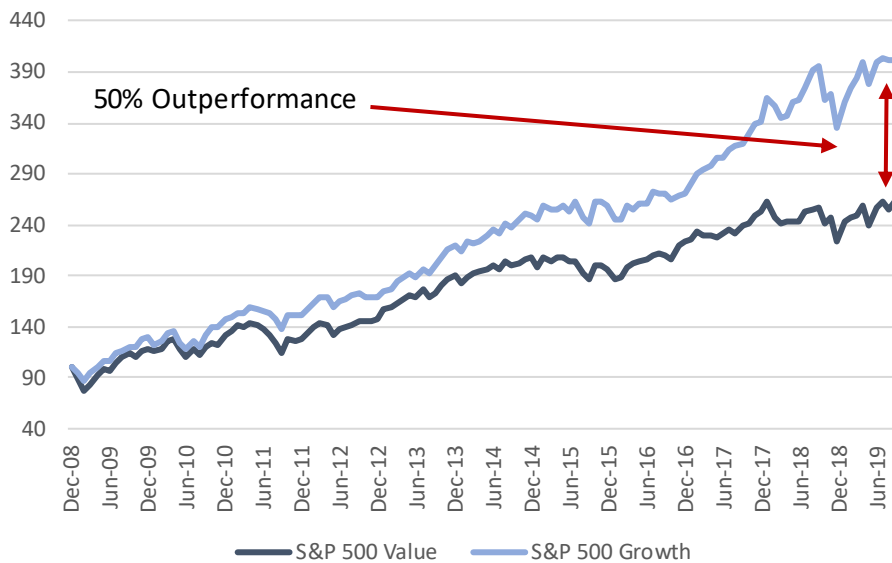
It seems like the debate between value stocks and growth stocks continues to make headlines, stemming from growth stocks' outperformance relative to value and the long-anticipated rotation back into value stocks. There is a widely held belief, allegedly supported by back tested data, that value stocks outperform growth stocks over the long-term.

While there is no official definition of value vs. growth, S&P Global measures value stocks using three factors: the ratios of book value, earnings, and sales to price. Growth stocks are measured by sales growth, ratio of earnings change to price, and momentum...whatever that really means. The charts below are for the S&P 500 Value Index and the S&P 500 Growth Index with data going back to 1994. We also looked at Vanguard's Value and Growth ETFs and the S&P 1500 Value and Growth indices which had similar results during the periods that data was available. Over the past 25-year period growth has outperformed. However, between 2004 through late 2007 following the dot com bust, value outperformed growth.



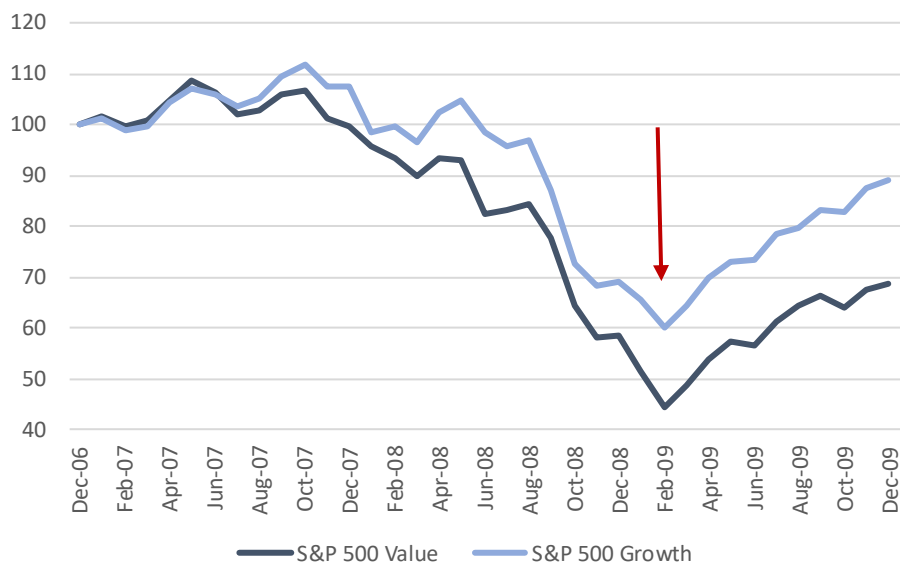
Source: Saga Partners, Factset Research Systems

Growth stocks have outperformed value stocks by over 50% since the bottom of the Great Recession.



Source: Saga Partners, Factset Research Systems

What's interesting is investors typically prefer value stocks because they are considered cheaper and are expected to decline less in a downturn or selloff. In the months leading up to the financial crisis, value stocks declined to a greater degree than growth stocks.



Source: Saga Partners, Factset Research Systems

We are not making a call on whether value or growth stocks will outperform going forward, or if one will perform better in the next sell-off. We are arguing that investing based on style labeling using simple definitions of value or growth is the wrong approach to begin with.

A company is neither cheap nor expensive because of where it sells relative to recent fundamentals. These classifications of value or growth are just a convenient box ticking, quantitative oriented practice used by consultants which can distort the investing process. While different styles, genres, or investing factors may go in and out of favor at times, at the end of the day, the value of a stock is all the cash that can be taken out of a company *going forward*.

Perhaps there was a time when information was less ubiquitous and fewer rocks were left unturned and buying a basket of stocks selling for a low multiple relative to earnings or book value would provide market beating results. While this strategy was still overly simplistic, it could have worked. In today's world where information is easily available, selecting a basket of stocks solely based on low multiples will very likely result in a pretty mediocre basket of companies on average.

Every investing decision should be a value decision based on what one estimates an asset is intrinsically worth; i.e. how much cash will be returned to shareholders, when cash will be returned to shareholders, and what interest rates are. This could mean we find a company attractive if it is selling for 5x trailing earnings, 100x earnings, or even if it has negative earnings.

I think Jeff Bezos defined intrinsic value best in Amazon's 2001 shareholder letter:

“If you could know for certain just two things—a company's future cash flows and its future number of shares outstanding—you would have an excellent idea of the fair value of a share of that company's stock today. (You'd also need to know appropriate discount rates, but if you knew the future cash flows for certain, it would also be reasonably easy to know which discount rates to use.) It's not easy, but you can make an informed forecast of future cash flows by examining a company's performance in the past and by looking at factors such as the leverage points and scalability in that company's model. Estimating the number of shares outstanding in the future requires you to forecast items such as option grants to employees or other potential capital transactions. Ultimately, your determination of cash flow per share will be a strong indicator of the price you might be willing to pay for a share of ownership in any company.”

The heart of value investing is based on the accuracy of the business analysis and then not overpaying for the business. This means giving a far greater weighting to qualitative factors such as a company's overall market opportunity, pricing power, durability of its competitive advantage, ability of management to allocate capital, etc.

Evolution of a Value Investor

Speaking of focusing on qualitative analysis, it seems as though the learning curve of a “value” investor often follows a similar path; at least this was the case from our personal journey and the few other portfolio managers we know that share a similar investing philosophy. Perhaps one of the most common tendencies of investors early on in their journey was relying almost entirely on quantitative metrics and underweighting the importance of qualitative factors of businesses and its managers. We were no exceptions.

The story often starts with a curious business student that comes across some narrative or writings about Warren Buffett. Their historically frugal self is quickly captivated by the idea of saving and compounding money by buying things for less than they are worth. Hungry to learn more, they read everything they can find on Warren Buffett, Ben Graham, Charlie Munger and all the other well-known value investors.

Anxious to grow their capital and working with relatively small sums of money, they try to emulate Buffett in his early days, searching the universe of publicly traded companies selling for low multiples to earnings, cash flow, or book value. There is just something appealing to paying 10x current earnings vs. 20x.

While the young investor experiences a few token successes, they start realizing that times have changed since the decades following the Great Depression and few of Ben Graham's net-nets

(companies selling for less than their working capital) exist. Too often when weighting valuation before quality, they find themselves owning mediocre companies that only appear to be selling for an attractive valuation but remain perpetually “undervalued” as operating results continue to disappoint. Although it is true that almost any asset can be attractive at the right price, it is very difficult to do well owning a bad business over the long term.

Additionally, if you buy something because you think it’s slightly undervalued merely based on some quantitative metric, then you have to think about selling when it approaches your estimate of fair value. If a good company is selling for 10x free cash flow and you think a more fair valuation is 15x, as shares approach 13x, is there still enough margin of safety to justify holding it? Trying to guess if the market will rerate the valuation multiple applied to a company is a tough game to play. The real big money is made by owning a handful of companies that compound business intrinsic value over decades; not so much from the occasional one-time closure of gap between price and value.

It becomes increasingly obvious that some of the best opportunities are companies that generate high returns on capital and require little additional capital to grow further. These opportunities exist because the market can underappreciate the intrinsic value since these companies rarely look cheap based on standard valuation metrics. If the market is selling for an average earnings multiple of 16x-18x, any company selling at a higher multiple looks relatively expensive, and any company selling lower looks relatively attractive. This may be a reasonable conclusion for an average company, but companies are not all alike and the difference between an exceptional company that is scaling and an average one can be huge.

As the young investors continues the never-ending process of learning and improving, they devote themselves to studying the exceptional businesses that exhibit competitive advantages; finally appreciating that the value in investing is in the qualitative analysis.

Compounders and Fair Valuation

Below is a list of some of the best performing stocks over the last 15 years (2004-2019). You could argue that Booking Holdings Inc. was undervalued by 24x in 2004, meaning that when shares were selling for \$20, they could have been selling for \$480 (26x sales) and still earned the market's return over the subsequent 15-year period. The 2004 fair value for Old Dominion Freight, a best-in-class trucking company, would have been 101x its 2004 earnings. Alphabet Inc., Google's parent company, could have sold for 73x its 2004 sales and 515x earnings to provide the market's return.

Company Name	15 Yr. CAGR (2004-2019)	2004 Shares Undervalued By:	2004 Fair Value Multiple	
			P/S	P/E
Booking Holdings Inc.	35%	24x	26x	678x
Apple Inc.	34%	22x	34x	468x
Amazon.com, Inc.	28%	12x	36x	618x
salesforce.com, inc.	27%	10x	386x	13072x
Tyler Technologies, Inc.	25%	8x	16x	264x
Credit Acceptance	24%	7x	14x	43x
IDEXX Laboratories, Inc.	23%	6x	12x	82x
O'Reilly Automotive, Inc.	22%	6x	5x	70x
Old Dominion Freight	22%	5x	5x	101x
Alphabet Inc.	22%	5x	73x	515x
Ross Stores, Inc.	22%	5x	3x	64x
Copart, Inc.	21%	5x	13x	52x
Domino's Pizza, Inc.	21%	5x	2x	45x

Source: Saga Partners, Factset Research Systems

Note: Returns calculated from 9/30/04 through 9/30/19

Obviously hindsight is always 20/20 in investing. It's easy to look back at which companies succeeded and others failed and we are not arguing that valuation does not matter. Valuation is crucial to investing, as is building in a margin of safety. There is not a more guaranteed way of getting low returns than paying too much for an asset, but you can see from the chart above how the truly exceptional companies with significant growth opportunities could sell for multiples that look ridiculous at the time when compared to market averages. It might just make sense to pay up a bit for the few exceptional companies out there.

There are just under 2,000 U.S. companies publicly traded today that were publicly traded 15 years ago. About 580, or 30%, of stocks beat the S&P 500's 9% CAGR over that period. In other words, in 2004 ~30% of public stocks were undervalued and ~70% were overvalued relative to the S&P 500.

It's interesting that significantly more companies underperformed the average market return. The few successful companies contributed more to the overall average returns. This sample size does not even include all the companies that either went out of business, were acquired, or taken private. Blindly picking companies from a bowl or having a monkey randomly throw darts at all available stocks in 2004 would likely not result in a winning strategy over the subsequent 15-year period.

There were about 190 companies (<10% available) that provided a 15%+ CAGR and about 70 companies (<4%) that provided a 20%+ CAGR. Was it possible in 2004 to determine that Booking Holdings Inc. would come to dominate the online travel agency industry, Amazon would be the e-commerce winner and start AWS, Credit Acceptance Corp's differentiated auto lending business model would not be replicated by competitors, or Google's search engine would establish monopoly status while Android became the primary cell phone operating system throughout most of the world? These are not easy business achievements to predict, but you did not have to predict all of these successes in 2004, just a token few would have worked.

Unfortunately we only have the information available today to help pick the winners over the next 15-year period. We are not trying to predict every business feat and we are certain to miss out on many big winners. But if we work very hard, we may be able to find just a few things every once in a while that are very likely to do well over time.

It is also important to remember that investors today do not profit from yesterday's growth and not all good investments have to be "compounders," that is just a good pond to fish in for the multi-baggers. Value can be found in many different corners of the market whether it's in higher growth compounders, more mature stalwarts, large cap, small cap, software, the trucking industry, auto lending, or used car parts.

The most important thing we have determined in our investing experience is sticking with companies that have some type of competitive advantage and then purchasing them at a price that provides an attractive return on their long-term estimated future earning power.

Conclusion

We are grateful for the opportunity to manage our investors' hard-earned capital. The success of the Saga Portfolio requires investors that are stable, long-term, and realistic in their expectations. We would love to continue to grow with like-minded investors (up to a certain size). If you know someone that may potentially be interested in the Saga Portfolio, feel free to forward on our information. The next date the Saga Portfolio will accept new investors is January 1, 2020. As always, please reach out if you have any questions or comments, we are always happy to hear from you!

Sincerely,

Joe Frankenfield, CFA

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