FRAZIS
• CAPITAL PARTNERS •

Dear investors,

Performance

The Fund was up 4.2% net of fees for the month, ahead of both the S&P500 and ASX200. Pleasingly this was due to a broad uplift in our portfolio rather than due to one specific trade.

Core investment portfolio

There were few changes to the core portfolio. We reduced a few positions showing strong profits such as CVR Refining and Glencore, though these were minor changes and we stayed invested. We also exited Bionomics to realocate to better opportunities. There were no major new positions, though we did add to our volatility hedges.

The Economic consequences of Donald Trump #1: Tax

There are three tax proposals driving markets right now.

a) Tax cuts

Cutting corporate tax to 15% is undoubtedly bullish. Markets are valued on after tax earnings, after all, and these can only benefit from a halving of what is, for many companies, their biggest cost.

Cutting corporate tax is good for share prices and indirectly, for corporate spending, but not necessarily society. The market is owned by the wealthiest, so this shifts the tax burden lower down the income curve. The Trump rally in stocks will not flow down to his hillbilly elegiac supporters.

The major advantage will accrue to those who own their own companies, including contractors, but ofcourse Trump himself and his family. That 15% is all they will ever have to pay, though given Trump's extensive disasters and bankruptcies, it will be a long time before those tax losses are used up anyway.

b) Immediate tax relief for capital spending

In my opinion this is a far more consequential and quite bullish as well. The proposal is that capital spending is immediately tax deductible. This means that a company paying that 25% tax would get a *25% discount on anything they purchase.* In other words, the Government pays 25% of anything a company buys that can be classed as capital expenditure.

If it passes, this could trigger a huge boom in corporate spending and investment. Companies will hardly ever, if ever, need to pay tax again. Most countries around the world would have to follow suit to avoid regulatory arbitrage.

Why such a strong effect? After all, capital spending is tax deductible now, just over longer periods, like ten years.

The key consideration is the incentive map of the decision makers. A ten-year depreciation schedule pushes most of the tax benefits well beyond the point where they would impact decision making. Very few people stay in the same firm or even industry for ten years.

Under the new rules a CEO would get an immediate and dramatic reduction in cash taxes paid. Capital expenditure is quite low on the priority list of managers, as buybacks, dividends and acquisitions are far more likely to boost equity values. The return on capital expenditure typically takes many years to realise, and is as likely to accrue to a manager's successor as he himself (or she herself).

The 25% discount (or 15% if the cut passes) also means that marginal investment projects become viable, increasing overall economic activity.

So who benefits most? My first take is that the effects would be shared broadly. Everyone benefits from increased investment. In fact, nations invariably boom when investment is high, and post sluggish growth when investment is low, such as the past few years. Investment involves growth, jobs and wage increases. Tax

revenues would decrease in the short term, but since capital expenditure is already deductible – albeit over very long time periods – the effects should be minimal, and counter-acted by increased activity.

c) Deductibility of corporate interest

This is a tough one and uncharted territory. Tax deductibility has been a feature of finance for centuries. There are some juicy debating points here, such as whether interest is a company cost or a return to capital. The impact is harder to call than the deductibility of capex above.

Those working in finance simply cannot spend enough time thinking about the intrinsic qualities of debt and equity, how they're compare, contrast, and the effect a changing capital structure has on company outcomes. This would shift incentives away from debt towards equity, and I think the policy is best viewed with this lens.

In short, debt is cheap, but induces fragility. Equity is expensive, but is far more robust. The current system provides a strong tax incentive for debt funding over equity, and hence growth and returns to capital at a cost to stability, though this would be impossible to measure empirically.

In a startling example of this, the current system incentivises companies to borrow tax deductible debt and buy back shares. This increases the fragility of companies, weakens their balance sheets and doesn't lead to additional economic activity (directly, anyway). It would be far better for Governments to encourage investment and spending.

A society with no debt would likely have lower growth and less crises. I am unsure where this trade-off lands, most likely it would depend where in society you sit. A society funded entirely by equity would have few crashes and crises, almost all of which become systemic through debt.

Some industries would be affected greatly, such as private equity. I doubt anyone would shed a tear for private equity analysts forced to recalibrate their models, but the whole economic rationale for deals would change. Highly leveraged strategies and financial engineering would be discouraged, while additional capital would flow into equity-like areas of the investment world, such as venture capital.

So overall, we can expect a more stable world with more funding for venture capital, and less funding for financial engineering.

Interest expenses are only a small percentage of the total capital, and tax-deductible part smaller still, so I don't think this is as significant on a society wide basis as the move on capital expenditure.

These proposals ensure that the Trump Corporation will never have to pay tax, though it will take decades for Trump to earn back the losses and bankruptcies of previous decades, even with his Washington hotel packed full of foreign diplomats. Coincidentally, for the reasons above, I believe some of this is quite good policy. Let's hope the documents are crafted by someone who knows how to spell.

Now for the bad

This is all sounds quite positive. But there are severe risks looming over the next four years. We have a President in the US that is so unstable that the smallest perceived slight induces a torrent of abuse. He has learned he can get away with anything, and his default response of violent attack and false information has been vindicated again and again. This will work until it doesn't, and is the product of an unhinged mind. Trump appears to be treating China with respect – respect not shown towards allies such as Australia and perceived trade adversaries such as Mexico.

I have written before that the key risk this year is the appointment of a hawk to the Fed later this year. But any crisis or conflict that demands an appreciation of nuance, a stable temper, or requires de-escalation will no doubt turn into a horror show.

There is much talk of a trade war. Trump has certainly started one with Mexico. As we have seen, the fall in the peso almost precisely equals the likely tariffs that would be placed on Mexican goods. This could be a taste for what's to come when Trump finally clashes with China. Should Trump dish out the same disrespect to China as he has to Mexico, markets will dislocate.

Capital outflows will dramatically intensify. The last two panics in September 2015 and January 2016 all coincided with depreciation of the Yuan. I never quite teased out this relationship, though it was reminiscent of risk-on / risk-off moves in other FX markets. This cross will bear close watching.

Our hedges are likely to be costly in this hard-rallying environment, but we will keep them on.

Final thoughts

The last year or so has been a welcome reminder that there are upside risks as well as downside risks to markets. Anyone who got spooked by China in January 2016, Brexit in June or Trump throughout will have locked in some serious underperformance. Fortunately, our two-way strategy kept us safe and generated profits from both the surprise crashes and surprise rallies.

The market rally may continue, and after-tax earnings may finally normalise valuations without requiring a major sell-off. However at some point this year I expect optimism over these changes to the tax code to finally fade or at least be comfortably priced in to markets. At this point impending rate rises by a new, hawkish Fed Governor and the accumulated harvest of incompetent management in the White House may finally halt this resilient bull market. We are prepared for either outcome.

Warmest regards
Michael Frazis

	ASX 200	S&P500	Frazis Fund Net
30-Jun-16	-1.5%	1.0%	-2.5%
31-Jul-16	6.3%	3.6%	5.4%
31-Aug-16	-2.3%	-0.1%	0.8%
30-Sep-16	0.2%	-0.1%	6.1%
31-Oct-16	-2.2%	-1.9%	-2.5%
30-Nov-16	2.2%	3.4%	3.9%
31-Dec-16	2.3%	2.7%	-0.1%
31-Jan-17	1.3%	0.8%	4.2%
Since Inception	**6.0%**	**9.5%**	**16.1%**

Major gross contributions to the portfolio were approximately:

Contributors	
KKR	0.6%
Navios equity	0.6%
Tata Motors	0.5%
Glencore	0.4%
Alibaba	0.4%

Detractors	
Volatility trading	-1.4%
Beach Energy	-0.3%
Lending Club	-0.1%
No other major losses.	

Exposure

Country	%
USA	32%
Australia	25%
UK	19%
Europe	11%
SE Asia ex India	8%
India	4%
Total	**100%**

Investment Theme	%
Financials	16%
Energy and Refining	12%
Tech	13%
British Land Developers	12%
Blue Chip Mining	11%
Mining Development	8%
Biotech and Pharmaceuticals	7%
Autos	7%
Luxury	5%
Shipping	2%
Other	4%
Total	**100%**

Short Positions	%
Technology	-2%
Energy and Refining	-5%
Total	**-7%**

Hedge book	%
S&P500 - covered with calls	-32%
Net Front Month Volatility	6%
Total Equity Exposure with VIX at 4x	**38%**

Credit and Macro	%
Credit Risk	5%

Long-dated US Treasuries	4%
EuroBund 10y	-14%