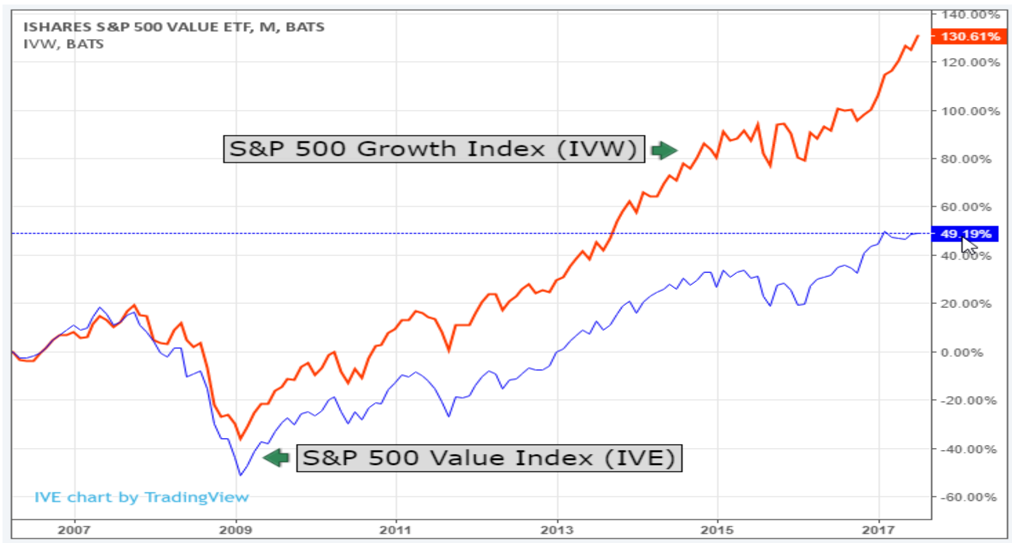
**July 2017**

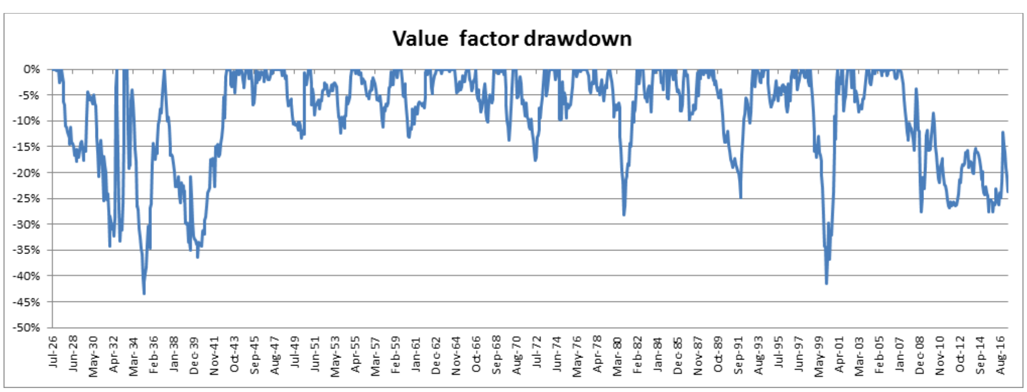
**Dear Vilas Fund Partner,**

The Vilas Fund, LP appreciated 0.7% in the second quarter, bringing the year to date performance to 4.1%. Since the Fund began on August 9, 2010, it has compounded at 14.26% (net) vs. the 14.14% (gross) return for the S&P 500 Index including reinvested dividends. So, in a nutshell, the Fund has basically tied the market over the last ~7 years, though we would think that by slightly beating the market as a value manager, we would rank fairly well in that light.

Over the last decade, the Value Index has drastically underperformed the Growth Index. As the following chart shows, the differential is roughly 75-80%.




Further, the duration of this underperformance, from 2005-2017, is near a record level, only surpassed by the Great Depression:




With this as a backdrop, it is clear to see why value managers have been suffering as the "new bubble" is inflating.

## Investment Strategy

As we have discussed in prior notes, we are value managers that purchase stocks selling at prices well below the level that we believe they would trade at in a "normal" environment. For example, if a company is earning a sub-par return on equity today due to temporary issues in their business, we may "normalize" the earnings and valuation multiple to determine where the stock would be trading if the company had a somewhat improved operating environment. For example, banks are earning lower returns on capital today due to interest rates and regulatory changes we deem to be "temporary". Also, a retailer that experienced a soft quarter due to a weak economy may be of interest. If oil prices are below the marginal cost of production, this is a situation that probably cannot last very long, potentially making energy firms interesting. And finally, if the market is anticipating an economic downturn in auto demand, as well as the fear that Tesla will "take over", and has sold the stocks to ridiculously low valuations, this may be of interest.

We are extremely careful to avoid businesses in permanent decline. Newspapers, in print form, are not coming back. Therefore, buying them at low valuations is a "value trap", in our opinion. At my former firm and many years ago, we owned a company called Great Lakes Chemical that produced a leaded gasoline additive to raise octane levels. The stock was very cheap and the company was very, very profitable but their revenue was in permanent decline. It was very difficult to make money in that stock as it eventually traded down towards liquidation value. Thus, we find that it is vital to make sure that it is cyclical factors affecting companies, not permanent issues. Thus, Sears, Gannett and JC Penney don't make the cut.

The banks and other financial services providers we own will never go away. There is no technology or other means to accomplish their role in society. Fintech, as they call it, will never supplant a major financial institution. Ever. Thus, these companies will eventually fully recover and thrive as they always have. Are they cyclical? Yes. But they will recover.

At the same time, we short companies at massively large valuations that, to be blunt, have lousy businesses from a financial and competitive strategy standpoint. We believe that, while in a bubble it looks foolish in hindsight, it will be very additive to our returns to be dragging these positions along. Earnings matter (GAAP, that is). Profits matter. Conservative balance sheets matter. Revenue growth does not necessarily mean a good result for shareholders. In business, trading dollars is easy. Earning money is hard.

## Investment Position Discussion

The New York Times reported in its June 17, 2017 edition about Amazon:

> ***"One thing the retailer did not do was make much money. In its two decades as a public company, Amazon has had a cumulative profit of $5.7 billion. For a company with a market value of nearly $500 billion, this is negligible. Walmart, which has a market value half that of Amazon, made a profit of $14 billion in 2016 alone."***

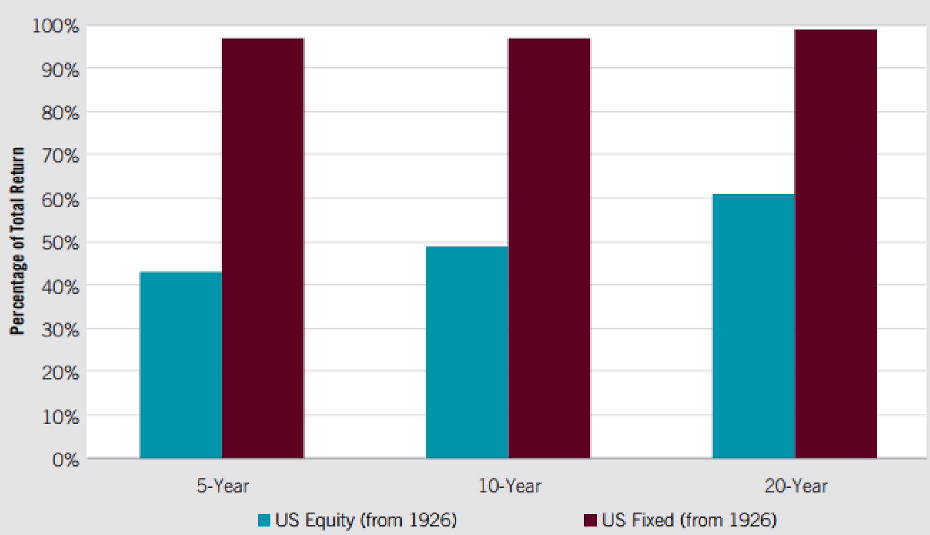
In my nearly 25 years of managing money professionally, I have never seen a valuation this high for a top 5 company in the S&P 500 Index. The reason that valuation matters is that shareholders deserve dividends (or stock buybacks) from their investments. If valuations get too high, the dividends become meaningless and negligible. In this case, if Amazon were to pay out all of its earnings, it would take over 200 years at today's earnings run rate to “get your money back” from investing in the company.

We like material dividends that grow over time and so does the market, normally. Over 60% of the historical return of equities has come from dividends. Therefore, almost every investment should be paying dividends currently or be able to easily afford to do so. Many of today’s glamour stocks, including both public and private issuers, not only can’t pay dividends, they are selling bonds and equity to finance themselves. This is opposite of what an owner of a whole business would want.

The following chart from Brandes shows that over rolling 20-year periods, dividends make up the majority of equity returns (and, for those that own bonds, the coupon is the return). Those who believe that “reinvestment” is always the best policy have a long string of data that shows the opposite is true most of the time.

**Exhibit 1: Dividend Income Accounted for More than 60% of U.S. Equity Returns Over Rolling 20-Year Periods, 1926–2014**

Average Income Component of Total Return Percentages from 5-, 10-, and 20-Year Rolling Data, U.S. Equity and Fixed Income




Source: Brandes Institute, based on data from Ibbotson Associates, Global Financial Data, Inc. and Factset, as of December 31, 2014.
Past performance is not a guarantee of future results.

## Holdings

In past letters, we have highlighted many of our short positions. In this letter, we would like to discuss our long positions in more detail. The Fund currently holds roughly $5 long for every $1 short. This helps protect our principal if the market for glamour stocks remains irrational and keeps "bidding up" the shares of companies with little to no earnings but who possess revenue growth. Again, revenue does not equal profits, a concept that many in the market seem to have forgotten.

Our long positions are concentrated in Financial Services, Automobile manufacturing, Healthcare, and Energy. In the Financial Services space, our average holding is trading at 0.86 times book value per share (we have excluded asset managers as they trade on earnings, not book value). This is extremely undervalued relative to history.

As an example, Barclays, our largest position, is trading at 0.56 times book value. In the not too distant past, Barclays had briefly traded over 5.0 times book value and regularly traded at 3 times book value.


While we doubt that those types of valuations will occur again in our lifetimes, we do think that over the next 5 years, Barclays will see its valuation expand to ~1.6 times book value. Why? Because the company has a great collection of businesses, including credit cards, retail banking, commercial banking, and investment banking. Collectively, they should earn a return on equity in the low teens and, when they do, we have seen most other banks trade up to that level.

The Global regulatory pendulum has swung about as far as it will in the "tight" direction. We sense that it is slowly starting to swing back the other way. This will allow for expanded returns. Second, the interest rate environment is about as bad as it can get for a Global/European Bank. As interest rates eventually normalize, because "costless money" makes no sense in the long run, this will also add to profitability. Thus, over time, we see a great business that should have some significant tailwinds. The market, however, sees a business that has paid fines, has massive regulatory burdens, is fighting Britain's exit from the EU, etc.

Our job is to predict the environment far into the future. The issues that are affecting the banks today are transitory and will improve over time. We expect a large valuation improvement on top of attractive earnings/book value growth. Sort of a double whammy.

Our second largest long position is Honda Motor Company. Honda earned $44 billion the last 10 years and paid out roughly $14 billion in dividends. Though it has a market cap today of $49 billion, which is only $19 billion above the amount of earnings it retained the last decade, its stock has fallen 22% in the last 10 years. The company grew its revenue 6.6% per year the last 10 years, through the worst economic episode in 80 years. If we assume a normal net margin of 3.5% and assume 5% revenue growth, Honda will earn over $82 billion in the next 10 years. Thus, we could buy the whole company and the earnings would "pay off the purchase" in roughly 6-7 years, at which time we would own the whole company free and clear. This is a ridiculously low valuation. We believe that Honda, which is trading at 0.78 times book value, should see its valuation multiple expand to 2 times book value and continue to grow earnings. A similar situation exists with Daimler AG, Ford and GM, all holdings of the Fund. It is as if the market is anticipating a massive recession followed by no recovery due to Tesla taking over the world. We don't believe that either will occur.

The Fund purchased a large position in Valeant at roughly $12.88 per share. We added to the position over time and were able to buy a significant number of shares when a Board member, who also runs an investment fund, sold their holdings at $11. The stock has since rebounded to roughly $17. The Fund also purchased Walgreen Boots Alliance the day that Amazon purchased Whole Foods because Walgreen's had fallen roughly 8% that day. We fail to see what Whole Foods has to do with filling prescriptions, but I guess we continue to be dense. The Fund has made a lot of money in Walgreen's over the years and we are glad that we got another bite at the apple due to the short-term selloff. The Fund also has a smaller holding in CVS and a decent sized position in Target.

And finally, the Fund holds a moderate position in BP and a tiny position in Transocean. We like BP's dividend and production profile. We are attracted to Transocean due to their optionality if oil prices were to increase. We are of the mindset that oil prices will likely trend lower due to additional supply and reduced demand from fuel economy improvements in the auto fleet and other energy users. However, calling energy prices is next to impossible and we like to have a small weighting in case there is a geopolitical event or OPEC regains its cartel power. Due to the large dividend BP pays, we get paid to have this “hedge” in place.

## Conclusion

We have been waiting for nearly 12 years, both at Vilas Capital and my previous firm, for value stocks to lead the market. To our chagrin, it has basically been growth stocks all the way for the last 12 years, with a few intermittent periods of light to keep our spirits from being totally crushed.

We believe that the markets are slowly turning towards value and, therefore, our strategy will soon be "swimming downstream" instead of upstream. If The Vilas Fund, LP could keep up with the market being long value stocks and short glamour stocks over the last 7 years, we should be able to beat it by a decent margin if value regains its footing.

Some have worried that all stocks will fall when the "bubble" pops. We believe that the markets will react along the lines of the 2000-2002 period whereby value stocks generally went up while the glamour stocks fell 80-90%. As evidence, we are finding that the Fund increases significantly, both on an absolute and relative basis, when the glamour stocks have fallen sharply a few days this past June.

We appreciate your investments with our firm and look forward to a profitable future.

**Sincerely,**

John C. Thompson


**John C. Thompson, CFA**
CEO and Chief Investment Officer

**Vilas Capital Management, LLC.**
The Aon Center, Suite 5100
200 East Randolph Street
Chicago, IL 60601

Office: (312) 702-1976
Cell: (608) 576-3938

Email: jthompson@vilascapital.com
Web: www.vilascapital.com

## Disclosures

Performance data represents past performance and does not guarantee future results. Performance includes the reinvestment of dividends and other earnings. Net performance is net of all fees and is based upon the current investors' fee structure. Future performance will vary depending upon each investor's capital account and fee structure. The Vilas Fund, LP's specialized investment program involves risk. A detailed review of the risk factors are described in the offering materials, which you should read carefully before considering an investment in The Vilas Fund, LP. The current performance may be higher or lower than the performance data provided herein. The Vilas Fund, LP, performance may not be directly comparable to the performance of other private or registered funds.

The Vilas Fund, LP, is a private fund and the securities are offered in reliance on an exemption from the registration requirements of the Securities Act and are not subject to the protections of the Investment Company Act. The Securities and Exchange Commission has not reviewed the securities or the offering materials. The Vilas Fund, LP, securities are subject to legal restrictions on transfer and resale and investors should not assume they would be able to resell them.

All information contained herein is subject to revision and completion. Should there be a discrepancy between the offering materials and this document, the offering materials will control. This document is not intended to be a complete description of the business engaged in by Vilas Capital Management, LLC, nor is it an offering or solicitation to invest. Any such offer or solicitation may be made only by means of a confidential private offering memorandum. No subscriptions will be received or accepted until subscription documents are completed and Vilas Capital Management, LLC, has approved the subscription agreement and an investor's eligibility to invest. Prospective investors must be accredited investors and must meet certain minimum annual income and/or net worth thresholds in order to be eligible to invest.

The S&P 500 Index represents 500 of the United States' largest stocks from a broad variety of industries and includes reinvested dividends. The HFRX Equity Hedge Index consists of equity hedge strategies that maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision and strategies can be broadly diversified or narrowly focused and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations and valuation ranges.

This presentation contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on the current beliefs and expectations of Vilas Capital Management, LLC and are subject to significant risks and uncertainties. Actual results may differ from those set forth in the forward-looking statements. Factors that could cause The Vilas Fund, LLP actual results to differ materially from those described in the forward-looking statements can be found in The Vilas Fund Confidential Private Offering Memorandum and Subscription Agreement. Vilas Capital Management, LLC does not undertake to update the forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.