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Fellow Investor

Via email:

Dear Fellow Investor:

Disclaimer
This letter is an attempt to lay out what I personally see as the investment case for this Fund, but it is not a document upon which one can rely when making an investment decision. Also, all the thinking herein is my own; I have not shown this document to anyone else. The investment decision requires the Fund's Private Placement Memorandum (PPM) which will be ready soon. Once the PPM comes out, it will supersede all previous documents relating to the Fund investment, including this letter.

A Different Approach
Former world chess champion Garry Kasparov observed in a recent column in The Wall Street Journal that "Without change, we are expecting a different result from the same behavior, something once defined as insanity."

This letter will discuss a different investment vehicle designed to achieve different investment results over time. Over the years, I have spoken with many of you about creating a fund to serve as the main investment vehicle for my own assets and to give investors access to a variety of asset classes and individual investments, while at the same time protecting against the risk of permanent capital loss.

This letter attempts to answer the questions that I would have if our positions were reversed and I were considering investing in a fund managed by you.

WHY NOW? DO YOU NOT BELIEVE THAT MANY ASSET CLASSES ARE EXPENSIVE?
Some numbers tell the story best. In the 1990s hedge funds average annual return was 18.3% per year. Since 2000, this number has fallen to 7.5% per year due in large part to the 30 fold increase in hedge fund assets from 1990 until today. As more money pours in, funds chase the same opportunities, driving up prices and driving down potential returns.

The increase in prices is best seen in the compression of risk spreads for assets. For example, Junk bonds are yielding about 3.4 percentage points above U.S. treasuries versus their historical yield of approximately double this number. As another example the average bond spread on emerging market countries has fallen to 172 basis points, a record low, with J.P. Morgan confidently predicting that they will fall to 150 basis points in 2007. These statistics reflect a trend in that many individual assets and asset classes are extremely expensive today. Professional money managers of all types, mutual funds, hedge funds, and private equity funds, in a desperate attempt not to underperform their competition in any given month, quarter, or year, have bid many asset prices to a level that does not begin to compensate for the risk of loss that investors are taking.

To me, however, such an environment offers compelling rewards to investors who do three things:

1. Explore sandboxes where few people play, thus ferreting out undiscovered and inefficiently priced assets.
2. Take a longer view by investing with a multiple year and not multiple month outlook. I believe in this point so much that I would not recommend investing in a fund like this one, and would certainly not agree to manage it, if the manager and the investors were not committed for a multiple year period.
3. Buy insurance against negative macro events. I believe that on a multiple year basis, the assets we are buying will perform very well. I also believe that today's environment with its historically low cost of risk offers a unique opportunity to buy insurance at a prudent price. Specifically, with 10% of the Fund's assets, I will buy cheap insurance against major market declines. In the best case scenarios, the cheap assets we are buying will appreciate while the price of risk also increases, thus making our insurance policies pay off as well. In the worst case, however, the 90% of our capital invested in under priced assets will be protected against negative market events that drive up the cost of risk.

WITH SO MANY HEDGE FUNDS, MUTUAL FUNDS, AND PRIVATE EQUITY FUNDS TODAY IS IT NOT DIFFICULT TO FIND CHEAP ASSETS? WHY CAN YOU SUCCEED AT DOING SO?

Yes, the extreme number of funds has made the markets hyper efficient in the short term period over which the funds invest. A quote in the July 2005 issue of Value Investor Insight from Legg Mason's Bill Miller, one of the best investors in history, illustrates the problem and the opportunity.

> When I was first starting out in the business, I was pitching R.J. Reynolds as a buy to an account in Boston. RJR was a conglomerate then, 1983, trading at 4X earnings. My pitch was that it was really cheap and was going to go up a lot over the next couple of years. When I finished, the chief investment officer said "That's a really compelling case, but we can't own that. You didn't tell me why it's going to outperform the market in the next nine months." I said I didn't know if it was going to do that or not, but that there was a very high probability that it would do well over the next three to five years. He said, "How long have you been in this business? There's a lot of performance pressure in this business and performing three to five years down the road doesn't cut it. You won't be in business then. Clients expect you to perform right now.
>
> So I said "Let me ask you, how's your performance?" He said "It's terrible, that's why we are under performance pressure." I said "If you bought stocks like this (R.J. Reynolds) three years ago, your performance would be good right now and you'd be buying stocks like RJR to help your performance over the next three years.

Miller's approach is extremely successful yet little imitated. Investors, and the army of consultants who advise them, continue to demand short term performance. This focus is an opportunity for those of us willing to adopt a longer term approach.

In addition, with part of its investments this Fund will actively seek out asset classes and companies that are ignored or shunned by the larger investment community. The following four are my four most recent investments:

1. Since 1996 the investors who have coinvested with me and I have realized net returns of approximately 20% per year on our investments in TriPro Partnerships.
2. In 2001 my coinvestors and I invested in Pacer Technology at approximately $3 per share. Two years later we sold our shares for about $6 a share after all fees, an approximate doubling in two years for an annual return of about 36% to investors.
3. In 2003 my coinvestors and I invested in Prince Henry Enforcement Partners, LLC a litigation fund designed to enforce our ownership in a private equity fund. Investors earned a net return after all fees and expenses of 36% per year (IRR) on this investment.
4. Most recently, my coinvestors and I made an investment in a small and little known Canadian company called Covalon for 37.5 cents per share. We just sold for 57.5 cents, a 53% increase in our capital in three months. This example is an aberration in that, in general, I have no capacity to make good investments over a three-month period. We got into Covalon because we believed that the 37.5 share price assumed a disaster scenario for the company. At this price, we thought it highly unlikely that we would lose money. Moreover, in concert with management, we believed that we could catalyze a few initiatives that gave us an opportunity to earn ten times or more on our investment. As the company achieved some of its operating goals, the share price moved up dramatically, and management lost interest in the initiatives that we had discussed helping them implement. This change reduced our valuation of the company's potential appreciation. Hence, we decided to exit the investment and redeploy the capital into more promising ideas. The most important lesson for me in Covalon is that a compelling price creates a tremendous margin of safety against losing money even if management does not act as I would prefer them to behave.

HAVE YOU EVER MANAGED A FUND LIKE THIS BEFORE?

No. For the last fifteen years, I have researched and selected individual investments in which individual investors have participated but not through the vehicle of an investment fund. This investment Fund, Prince Henry Navigator I LLC, will be the combination of a series of individual investments similar to the four previously done and described above.

HOW "RISKY" DO YOU THINK THIS FUND WILL BE?

In reality, the first and most important goal of this Fund is not to lose. I am very much focused on "heads I win, tails I don't lose very much" types of investments. Pacer, Covalon, and TriPro are all typical examples of these types of investments. I can talk all day about our focus on preserving capital, but the section below on incentives should be worth 1000 words.

IF THE FUND WERE STARTING WITH $100 TODAY WHERE WOULD YOU INVEST IT?

The simple answer is that I will always invest where I perceive the greatest discrepancy between risk of possible permanent capital loss and the opportunity for compounded capital appreciation over time. In addition, I will focus on making investments that have low correlation to one another. Said another way, each of the pool's investments will have different drivers. A one hundred position portfolio has no meaningful diversification if one macro event tarnishes the value of all one hundred positions.

With the above caveats in mind, here is an idea of where we would deploy $100 today.

1. $10: "Insurance Policy". I hope that this $10 bet expires worthless at the end of six years because it will mean that we have six years of wonderful Goldilocks type economic conditions, and the other $90 should have achieved extraordinary success. However, the first rule of investing according to Warren Buffett, and most investors whom I respect, is not to lose. (Incidentally, this rule does not mean that all investments work. Rather, that on an overall portfolio basis the weighted average of the winners outweighs that of the losers.) Given my focus on preserving capital, two elements excite me about this insurance policy:
    a. This "insurance policy" is cheap right now: the overwhelming market expectation is rosy. This investment position, managed by Point Clear Capital Management, is based on the fact that the "Risk Premium" of spread between corporate bonds and U.S. Treasury securities is at an all time low, and this spread cannot go to zero. However, any unexpected negative market event would increase this risk spread and deliver a multiple return on our investment.
    b. Assets are priced for perfection: a and b are interrelated in that because no one is worried about anything, great assets and rotten assets are priced at very similar prices. For a little bit more yield investors are willing to accept much greater risks of capital loss. In addition, investors are buying these risky assets by using historically unprecedented amounts of borrowed money. When this "irrational exuberance" ends, (this change could be several years from now) our $10 insurance policy has a high probability of being worth $25 or more.
2. $30: TriPro Partners pool. I have been investing with TriPro since the mid 1990s and, as mentioned above, have received net returns exceeding 20% per annum. Today, Navigator I will co invest with TriPro's owners in a pool that will invest a wide gamut of TriPro partnerships. Navigator I will receive a preferred return on the pool, i.e. TriPro's owners do not get paid unless Navigator clears predefined hurdles on its investment. I expect the TriPro Pool to offer Navigator I net annual returns of at least 20%.
3. $30 Pabrai Funds: Modeled on the Buffett Partnerships of the 1950s, Mohnish Pabrai, since 2000 has achieved annual returns of 25.2% vs. .5% for the S&P 500, -7.3% for the NASDAQ, and 3.7% for the Dow. (For actual data, please see www.pabraifunds.com username is pabraifunds and password is warren.) For a multitude of reasons, I believe that Pabrai's future returns have a high probability of exceeding the fabulous results he has earned to date.
4. $30 Special Situations, Hedge Funds, and Best Ideas: Navigator may invest in the hedge funds below and in a few others as well. We expect these funds to continue to earn compelling real returns and to meaningfully outperform the market averages.
    a. T2 Partners
    b. Seidman Investment Partnership
    c. Hawkshaw Capital Management
    d. Sellers Capital
    e. Lane Five Capital Management
    f. Value Act Capital

    In addition, Navigator will buy the best ideas that come from our investments in the hedge funds and from our diverse idea origination base. Our goal here is to find investments that achieve annual returns of approximately 25%.

If we assume that our 10% invested in the insurance policy expires worthless and that TriPro generates 20% per annum, Pabrai 25%, Special Situations 25%, then The Fund's expected, not predicted, return would be (10%)(0) +(30%) (20%) + (30%) (25%) + (30%) (25%) = 0+6%+7.5%+7.5% or about 22% per year. This calculation is no guarantee. We could lose money in every single investment.

<u>WITH YOUR MONEY WILL YOU PAY THE SAME FEES THAT INVESTORS DO?</u>

Yes.

<u>FUND MANAGERS OFTEN EXEMPT THEMSELVES FROM FEES: WHY ARE YOU PAYING FEES?</u>

As discussed in the answer to the incentives question, I want to create the biggest possible alignment of interests between the investors and me.

<u>YOU ARE FOND OF QUOTING CHARLIE MUNGER AND DISCUSSING THE "SUPERPOWER OF INCENTIVES". HOW WILL INCENTIVES DRIVE YOUR INTEREST IN THIS FUND?</u>

Let's examine three cases:

1. The Fund loses money: I will own the "Junior Piece" of this Fund. Specifically, we will invest $100,000 or forty percent of my total $250,000 investment in the Fund's "Junior Piece".   The "Junior Piece" will absorb 100% of the Fund's losses until the "Junior Piece" is eliminated. Let's take an example. We raise $3M of Senior Assets.   I invest $100,000 in a "Junior Piece". After six years the Fund has a $90,000 or 3% loss. I lose $90,000 or 90% of my $100,000 but investors get 100% of their $3M back.
2. The Fund does OK: I, the manager receive no performance fee unless the Fund delivers outstanding performance. Specifically, unless investors receive returns of 13% per year, I get no performance fee. I do receive an annual management fee of 2% per year which is a normal fee on a hedge fund and close to the 1.5% average annual fee on a mutual fund that invests in U.S. equities. Unlike a hedge fund, where the manager assesses performance fees annually and before investors get their money out of the Fund, this Fund will only charge performance fees once: at the Fund's conclusion after investors have received all of their invested capital and have compounded that capital at a better rate than the Fund's very generous 13% preferred return.
3. The Fund does great: After satisfying the 13% annual preferred return, I get 50% of the profits and investors get 50% of the profits. An example: the Fund's preferred return is 13% per year or (1+.13)^6 or 2.08X the investor' s original investment. Thus, if an investor invests $500,000 in the Fund, the first ($500,000) (2.08) or $1,040,000 goes to the investor. If we assume that the Fund delivers 20% annualized performance or about 3X the initial investment for a total of $1.5M, then the investor and I split the $460,000 ($1.5M-$1,040,000) that remains $230,000 apiece. In this case the investor would receive a net return of $ 1,270,000 or ($1,270,000/$500,000) ^(1/6)-1 an annual return of about 17% per year.

In sum, the incentives indicate that I am optimistic that we will not lose principal in this Fund and that we can compound capital at a very compelling rate over time. The only other explanation for why I would offer to manage a fund on these terms is that I am either most imprudent or insane!

<u>WOULD YOU CLASSIFY THIS FUND AS A FUND OF FUNDS, A HEDGE FUND A PRIVATE EQUITY FUND OR WHAT?</u>

None of the above. First, I know of no other fund that has a fee structure similar to this one in which the manager loses $100,000 of his capital before the investors start to lose any of theirs. Second, we will invest in a range of asset classes and assets depending on what appears most attractive to us at the moment. A year ago, I could never have predicted Covalon, but it represents the quintessence of the "Heads I win, tails I don't lose much" return to risk of permanent capital loss profile that we seek.

<u>MOST FUNDS NEED AT LEAST $50M OF CAPITAL TO BREAKEVEN? HOW CAN YOU AFFORD TO RUN THIS FUND?</u>

I am already investing my own money and that of my coinvestors in the same way I will invest the Fund. As such the Fund does not require a large infrastructure. I will be the only employee. If I hire people to help me on specific investments, I will pay them, as I do now, as independent contractors on an as needed basis.

<u>AS AN INDIVIDUAL INVESTOR, WHAT PERCENTAGE OF MY ASSETS WOULD YOU RECOMMEND THAT I PUT INTO THIS FUND?</u>

I would not make such a recommendation, and I encourage you to discuss it with your individual financial advisor. I will tell you, however, that we will not accept any percentage larger than 20% of an investor's liquid net worth. In this fashion, our fund can play a meaningful role in preserving and growing an investor's portfolio but also enables broad diversification with at least 80% of the investor's other liquid assets deployed elsewhere.

<u>WHO SHOULD NOT INVEST IN THIS FUND?</u>

1. Anyone who does not meet the Accredited Investor qualification tests.
2. Someone who has set up a family office to invest his capital has, hopefully, achieved much of the benefits we are looking to provide with this fund. I would welcome this investor, but our fund would not be as novel an addition to his portfolio as it would to our targeted investor base.

<u>IN WHAT ENVIRONMENT WILL THIS FUND LIKELY UNDERPERFORM?</u>

In a rapidly rising market like that of the late 1990s or 1960s, this Fund will very probably underperform the market indices.

<u>PARTING SHOT</u>

My goal is to create a vehicle that gives investors access to investments that they would not or could not replicate on their own. Over a six year period, I seek to find inefficiently priced assets that enable us to first preserve capital and then to grow at the highest possible rate with the least risk of permanent capital loss.

To those of you who share this mission, I thank you and encourage you to join me in the Fund.

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Sincerely,

Dan Anglin