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August 2018 - Performance Update

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The Moat Around Our Investment Process

Last month, I discussed LRT's investment strategy and how it differs from most traditional "value" investors. This month's comment further illustrates how the LRT process is both repeatable and sustainable.

At LRT, our success results from a consistently executed disciplined and differentiated investment process. We vigilantly focus on identifying "great companies". However, no company is so great that it commands an infinite price. Similarly, no investment process is worth following if it is not repeatable (who wants random or one-off alpha?) and sustainable (how will you know it's no longer working?).

What's not repeatable?

It's easier to discuss what we don't do because we believe it to be non-repeatable. We acutely understand you are highly selective with whom you choose to establish an investing relationship. As such, your comparative analysis in evaluating managers should focus on operational soundness and most importantly on critical points of investment process distinction that enables the continual protection of capital and generation of sustained portfolio performance. This requires discerning aspects of a non-repeatable process:

- **One-off macro calls, i.e., "the big short"** – Macroeconomic events are unpredictable. We do not try to time the market or make macro calls.
    - To profit from a big macro call one has to accurately predict non-consensus and far-from-equilibrium events. In LRT's opinion, entertaining books like "The Big Short" do a disservice to investors by highlighting a small group of people who correctly predicted a one-off event that has a high probability of not repeating. Such writings omit the thousands of people making various macro calls every year that turn out to be busts.

- **Sourcing ideas from colleagues** – At LRT, we execute concentrated, high-conviction investing. Our process requires conducting our own research to reach sound conclusions and foster unique ideas to support our solid convictions. We do not source ideas from other fund managers.
    - Can people be objective if they must defend their ideas (because they previously recommended something to you)?
    - Will your friends tell you when to sell as well as when to buy?

- **Outsourcing idea generation** – There are numerous firms that sell research and ideas. We do not outsource idea generation.
    - If you subscribe to such as service, do you know who is really generating the idea?
    - How do you know if the person changes?

    - How can you control and have confidence in the process they use?
    - How would you know if it changed?

- **Guessing next quarter's earnings** – Many investors engage in the futile game of predicting quarterly earnings. Company managements with the happy assistance of Wall St. analysts reciprocate with their own game of "beat and raise" and quarterly "guidance". We do not try to predict next quarters earnings.
    - Simply, long term investment success based on guessing quarterly earnings is NOT possible. Success guessing quarterly earnings means violation of a basic tenet that markets are efficient. Furthermore, many companies report earnings that "beat" expectations but management guidance disappoints and the stock falls. Needless to say guessing quarterly results as a repeatable investment strategy is a non-starter.

What's not sustainable?

Quantitative market information is readily accessible, even ubiquitous and consequently priced in by the market very quickly. Even if it is not priced in, and if one could build a quantitative trading system, how do you know if and when the system stops working? Imagine this: A pattern is discovered in the data and is deployed as a trading strategy. Almost all quantitative strategies, i.e. "momentum factor investing" have periods when they outperform and periods when they underperform. Systematic quantitative strategies require strict adherence to the system and its trading rules, which begs a few key questions:

- How long can your "secret" quantitative formula remain a secret?
- Do you believe that you can really outperform the market by applying a simple formula, like picking low EV/EBIDTA stocks?
- Why should a quantitative strategy that is widely known and widely publicized continue to outperform?

Perhaps, in the history of investing there have never been more people, with more algorithms and more data, all looking for an "edge". Investment strategies based on quantitative approaches are subject to quick competitive arbitrage. Subsequently, their outperformance does not persist.

The path to a **repeatable and sustainable** investment strategy is extremely difficult despite the performance of some passive approaches of the last few years. Our fundamental belief is that only a qualitative and concentrated investment approach can lead to sustained superior investment performance.

Qualitative insights are first and foremost about the future but are hard to find and harder to interpret. On the positive side, qualitative information is difficult to assemble, disseminate and be appreciated by the market. As such, its arbitrage through machines and algorithms is challenging. By example, Chegg (NASDAQ: CHGG), is a company in transition from the fast-declining business of renting textbooks and towards the growth business of education software and tutorials, but until recently all the past financial data reflected the textbook rental business. As CHGG changes its business model, the financial future of the company should look very different than the past, and it is in these types of situations where the stock price appreciation is the greatest – when the future looks very differently from the past (a REIT that doesn't pay a dividend begins to pays one, a company transitions to a more stable business model, a once unprofitable company starts being profitable, etc.). A quantitative approach would never pickup on this crucial insight.

Qualitative information is a persistent source of market inefficiency. Being focused on qualitative investing requires concentration – both because it is impossible to have high quality insights about a large number of investments and because concentration is the best way to make sure the value of your insights has an impact on the portfolio. Why are qualitative insights not disseminated quickly through the market place and arbitraged away? Because true insights require changing preconceived notions and ideas – something that goes against the human condition. Let me give you an example.

I was born in Warsaw, Poland and emigrated to the United States as a teenager. For many years, I did not visit Poland due to educational responsibilities and entrepreneurial pursuits. After the birth of my son, I returned to Poland with my family on a vacation. Both my wife and I loved our time in Poland as we visited several cities and had a wonderful experience. The country has several desirable attributes as a destination for a summer FAMILY holiday: The country is approximately the size of the US state of New Mexico. English is widely spoken, it's not overcrowded with tourists (few lines and little waiting), the weather is pleasant (warm but low humidity), children can be well-entertained, and it's very affordable for the budget conscious offering great value for the money with a plenty of hotels, restaurants and attractions (beaches, mountains, lush forests and historical cities) of high quality without breaking the bank.

Since my return to Poland, I have found it to be among my favorite destinations and have been telling others with enthusiasm all the reasons listed above why it is a great destination. My "pitch" for Poland is based on qualitative information – however, to date no one has taken my "recommendation". A family vacation in Poland is an example of an undervalued asset – one that is consciously avoided by most tourists and underpriced as a result. The unfortunate truth is that most Americans still trod the well-worn road to London, Paris and Rome on their first European trip as opposed to the "road less travelled" to Poland! Vacationers, like investors, continuously gravitate to the known, to the familiar and the comfortable. They adjust their views too slowly, especially when the information is qualitative.

In a meeting of the local CFA society, if an investment in a Polish specialty retailer, Dutch food ingredient company, a Brazilian tech company, a Swedish industrial company, or even an obscure but "optically expensive" US small cap company were discussed – how many would seriously investigate and consider investing, especially if said companies "screened quantitatively poorly" by conventional metrics (P/E, EV/EBITDA, gross margin, etc.). Many investors gravitate to familiar investment ideas: long/short Tesla, the "undervalued" Wells Fargo, cord-cutting and Netflix, or how cheap Apple appears. It is very difficult to convince people to consider the unexpected, the unusual, the under-followed or the out-of-favor company. Pre-conceived ideas and "narratives" about companies or sectors are hard to overcome and slow to change. Herein lies the fundamental opportunity that LRT consistently exploits: Qualitative insights, which are hard to obtain, are our source of sustainable opportunities for outperformance. By focusing first and foremost on qualitative information, we have a sustainable edge over most market participants, who overwhelmingly seek the comfort of the herd mentality in quantitative information and confirmatory bias as the primary inputs into their investment processes.

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Per our new format, I will discuss two current portfolio holdings with a common thread. This month's theme is "toll roads" in global capital markets. Love them or hate them, capital markets are a fact of life. Bonds, stocks and other investment products are an enduring feature of a modern capitalist economy. **Moody's** and **S&P Global** are two companies indispensable to the efficient, effective and economical functionality of modern financial markets.

Moody's (NYSE: MCO), S&P Global (NYSE: SPGI)

At LRT, we strive to own a collection of exceptional businesses with models that allow for high rates of return on capital not only today but for many decades into the future. Most businesses with very high rates of return on capital operate in small markets which are inherently less competitive: Think WD40 or the lone convenience store in a small town. On the other hand, there are businesses that operate in very large global markets, which tend to be very competitive: Think of the automotive sector, US groceries or international freight. It is very rare to find a company that has both high rates of return on invested capital, operates in a huge market and continues to grow faster than global GDP.

The most attractive business model in the world is to insert yourself as a small "tax" on a very large and growing market. In the world of advertising Google and Facebook are such businesses, taking a small but growing slice of all global commerce as they dominate online advertising as more and more ad dollars migrate online. In the world of capital markets Moody's and S&P Global are such businesses. Together Moody's and S&P dominate the global debt capital markets via the business of fixed income (bond) securities ratings. Besides ratings, they also have other good businesses, but these pale in comparison to the importance of their ratings businesses. At LRT we own both Moody's and S&P Global – we believe these are massively undervalued business with incredible moats and decades of profitable growth ahead of them. Moody's and S&P each have two business groups: ratings and analytics. S&P also has a third group: indexes. Let's look at each area.

Ratings (Moody's, S&P)

Imagine that you own a bridge with a toll both connecting two parts of a small city split by a river. This would be a nice business as long as you were there only bridge in town. Now imagine that the government has to issue bridge building permits and they loath to do so, limiting your potential competition – in fact there are only a few other such bridges. Now imagine it is not just a small town but that its global – a bridge linking two large continents. There are alternatives to your bridge crossing – going by boat, swimming, etc., but your bridge is by far the best option. Now imagine that every time a car goes across your bridge its capacity to handle traffic expands – automatically and at no cost to you. This creates a self-reinforcing cycle with more and more drivers choosing your bridge over that of your competitors. In this imaginary world there are really only two bridges worth driving across. Further imagine that the bridge never deteriorates and requires no capital to maintain. Finally, imagine that you set the price for this bridge crossing free of government regulation and interference. Lastly, even when your bridge is unreliable, and people die crossing it you can claim that they were crossing at their own risk – and the government promptly leaves you alone without much further ado. This "bridge" is the bond ratings business of Moody's and S&P.

Companies wanting to sell debt in the capital markets MUST obtain a rating for their debt. Most institutional investors have a stated investment policy that "mandates and restricts" the purchase of certain fixed income securities to those that have a rating from a NRSRO (nationally recognized statistical rating organization) and are prohibited from purchasing debt that is unrated or rated by an agency other than a NRSRO. As such, a seller of debt must pay Moody's or S&P for a rating if they are to have any reasonable hope at selling their debt. They overwhelmingly choose Moody's or S&P. Why? Primarily, because of "imbedded regulatory mandate". It is hard to overstate just how tightly Moody's and S&P's ratings are stitched into the fabric of modern debt capital markets compliance infrastructure and the day-to-day workflows of analysts and traders.

The US government limits entry into the ratings business by conferring on the chosen few NRSRO status and has effectively creating a duopoly with Moody's and S&P, despite two additional firms with NRSRO designation: JCR and Egan Jones. However, neither confers as much legitimacy as the dominant players.

Moody's and S&P are considered the "go-to" **standard** resulting in substantial market share in the global debt capital markets securities issuance. For issuers and investors, deviating has enormous costs as Moody's and S&P are self-reinforcing standards that offer interest savings in the multi-trillion dollar debt capital markets. Simply, obtaining a rating (as opposed to selling an unrated debt) far outweighs the cost of the rating.

When things go horribly wrong, as they did in the mid-2000 with subprime debt, NRSROs simply fall back on the "1st amendment" by stating that ratings are simply an opinion. During the subprime bubble, rating agencies clearly put profits before integrity, as the buyers of many subprime securities soon found out. And yet, even this did not destroy these businesses – a testament to how wide the moats of these businesses really are.

The ratings businesses of Moody's and S&P are clearly great businesses with operating margins over 50% and very high returns on invested capital. But that's not all. They are global business and they are growth businesses. Each year, global debt grows faster than global GDP. According to some estimates, the global debt market exceeds $100 trillion. By contrast, the value of the global stock market is around $64 trillion. As companies industrialize, debt capital markets play a larger and larger role in financing. Corporations wishing to access the global debt capital markets must pass through the "toll booths" these companies control, and they do so willingly because the benefits conferred by a rating from Moody's or S&P are immense.

In summary, the bond ratings businesses have nearly insurmountable barriers to entry and astonishing margins. These businesses are also recession proof and grow revenues at 7-8% per annum with ever expanding margins. Finally, they are incredibly cash generative as they require no capital expenditures and thus generate prodigious cash flow. At LRT, we consider Moody's and S&P truly crown jewels.

Analytics (Moody's, S&P)

Next to the ratings business almost every business on the planet looks substandard. Moody's and S&P Global both have analytics businesses, called unimaginatively Moody's Analytics and S&P Market Intelligence+Platts, respectively. These businesses are a collection of risk management, research, and data products and services. These "less good" businesses nevertheless grow revenue at amount 10% per year with operating margins in the high 20s and require no capital reinvestment. What's more, these businesses are sticky with a high % of recurring revenue and largely recession proof: they provide tools and data that indispensable to risk managers and analysts in the financial industry. Outside of Moody's / S&P, these would be great businesses in their own right, but they simply pale in comparison to the profitability of the ratings operations.

Indexes (S&P)

Finally, S&P Global has a wonderful business called S&P Dow Jones Indices. The indices business is dominated by a duopoly of S&P Dow Jones and MSCI. MSCI is a wonderful standalone public company, and almost everything in this section applies to it as well.

S&P Dow Jones Indices is a provider of index data asset managers and institutional investors. Just like the ratings business it benefits from being an entrenched, self-reinforcing standard. Every asset manager wanting to use one of S&P's benchmarks pays a licensing fee to S&P. They do this because their institutional investors want them to benchmark against an established standard which is provided by S&P. The company continues to innovate and add products to cover things like "smart beta", factor investing, ESG and emerging markets. The business requires no incremental capital to grow, grows revenues at low double digits annually and sports operating margins of 70%.

In summary, S&P Global and Moody's are wonderful businesses that almost always trade at remarkably low valuations. They convert over 25% of their revenues to free cash flow, are growing overall revenues at approximately 7% per year and yet trade at a low 20x their free cash flows per share. From these valuations they can continue to growth per share value at 15%+ per year for decades to come. So why the low valuations? The culprit is the usual one: fretting over the short-term issues: what will revenue be next quarter? What are the trends for the global economy? What will bond issuance look like next year? How much of the revenue is truly recurring and how much is transactional? These are unanswerable questions. What is knowable is the longer-term trends: Growing global wealth, a growing corporate dependence of global debt capital markets and the durability of these companies' moats.

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