November 9, 2018

October 2018 - Performance Update

If you are an accredited investor, please contact us for performance information.

Fighting the Last War

At LRT, as "bottoms-up" stock pickers we focus on the analysis of on a specific company's stocks and its fundamentals, rather than on the industry in which that company operates or on the greater economy as a whole. Our approach dictates LRT focus on factors such as, a company's overall financial health, analysis of financial statements, the products and services offered, supply and demand, and other individual indicators of corporate performance over time. From our objective, we seek individual companies that can do well even in an industry that is not performing. We de-emphasize the significance of macroeconomic cycles and market cycles.

With that said, we typically refrain from commenting on macro issues. However, in recent weeks mild concerns about the macro economy have led to overblown fears, which have affected the financial markets and impacted the LRT portfolio. As such, it is appropriate to provide some insight into what we see in the economy overall and how it affects the companies we hold in our portfolio.

Currently, there are several macro-economic themes that investors are focusing on:

- **Weakness in emerging market economies** – This weakness can be directly tied to China's slowing economy. The Middle Kingdom's economic expansion has slowed sharply in the past few months and with it most economies in Asia. The "Asian contagion" continues to spread to others through the trade channel. In addition, less-developed countries that rely on US dollar financing have been under pressure as US interest rates rise and liquidity has tightened. Tightening US liquidity has multiple sources beyond rising interest rates: US tax reform (which has made locating investments in the US more attractive), quantitative tightening by the Federal Reserve bank and the expanded US budget deficit, which competes for funds with the rest of the world.
- **Rising labor costs** – Another source of worry has been the rising cost of labor in the United States with many companies warning about worker shortages and rising employment costs. Investors fear that much of these cost increases will not be passed on to end consumers but rather absorbed by companies in the form of declining profit margins.
- **Trade wars** – The full realization of trade wars is finally upon us. Trump's initial trade skirmishes were ignored as only posturing, but their full force is now being felt by corporate American and soon consumers. Companies across the economy are warning about rising steel prices and Chinese import costs. Many businesses continue to report solid profits but have issued guidance warning about the impact of higher costs ahead, especially if the administration continues its trade war with China, as additional tariffs are scheduled to go into effect on Jan 1st 2019.

- **Perceived market "expensiveness"** – Many investors have long been skeptical of the continuance and strength of the longest bull market in history. The stock market is perceived by many as "expensive" but most remain invested as the 'TINA" ("There Is No Alternative" to stocks) predominates due to persistently low interest rates. With short-term interest rates now over 2%, some investors are beginning to re-balance portfolios, moving money to short-term cash instruments and out of stocks, effectively taking some chips off the table.

At LRT, forecasting the macro-economy is not within our core competency but we do conduct analysis to consider how portfolio companies will perform in different scenarios and economic climates. LRT's assessment of any company always evaluates three (3) key attributes:

1. The competitive advantage, i.e., "moat"
2. The growth opportunities
3. Management's capital allocation

When buying shares in a company, we think of ourselves as owners of a business not a piece of paper (or electronic record) called a stock. As such, our expectation is to hold investments through an entire economic cycle; expansion, recession, all of it. We do so because:

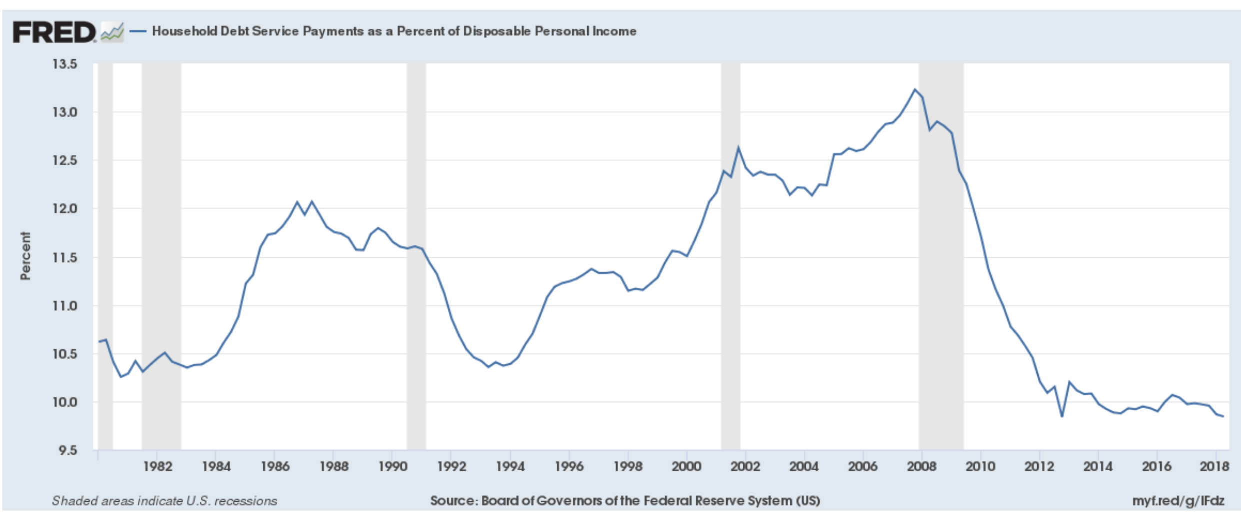
A. We don't believe we or anyone else can accurately and consistently predict the macro economy,
B. We believe the value of any business depends on its long-term prospects, not just what happens next year or next quarter.

As such, we fully expect the companies we invest in to have periods of weakness, from a few months to even a few quarters, when earnings decline from previous highs. For a long-term owner of a business, a single year of weak performance for a business caused by normal economic fluctuation does not impact its long-term value significantly, but many market participants continue to myopically focus on short-term results. This leads stock prices to fluctuate much more than underlying business fundamentals and occasionally provide LRT an opportunity to acquire shares in exceptional companies at bargain prices. Such times are an opportunity for outperformance, not a reason to panic. We firmly believe now is such a time.

Currently we have identified no major weakness in the US economy. Wall Street is often full of sound and fury signifying nothing. Durable goods orders, industrial production, gross domestic product growth, consumer prices, retail sales, employment, personal consumption expenditures, auto sales, home price, housing starts, consumer sentiment, the index of leading indicators all appear to have solid footing. One area that may have a bit more turbulence is home sales, which is highly interest rate sensitive. There has been a slowdown in new home sales and mortgage loan originations, suggesting that recent rate increase are affecting buyer demand – but a similar pattern occurred after the 2013 taper tantrum and was transitory. *A full set of charts is included in the appendix.*

We believe that the most reliable indicator of an economic slowdown and a precursor to recession is the access to credit. Credit spreads for low-rated borrows (junk credits), increase before recessions as investors no longer want to take a chance on high-risk companies. If credit spreads increase dramatically, we will become concerned about the cyclical prospects of the US economy, but until that occurs we remain sanguine about the economic expansion. The chart below depicts current credit conditions. As you can see credit spreads are at historically low levels, indicating no financing stresses in the economy.

The sharp drop in the stock market is a reflection of investors **anticipating** a worsening of macroeconomic fundamental, particularly industries connected to the state of US housing: Banking, home building, paint, air conditioning, pool construction, timber, etc. There has been no change in company fundamental over the past six weeks that would justify a drop of 10-20% in prices, as has been the case with many of our portfolio holdings. The change in prices has been driven entirely by changes in market sentiment about their future prospects. At the same, time there is little to no indication of major weakness in the housing market or the overall economy. Companies are reporting record profits despite being cautious about the future, with most citing trade wars and rising labor costs as risks. Specifically, to the housing market, there are also no signs of excesses like those that occurred in the previous housing boom. The number of new homes built in the US is still at very low levels, with current housing starts at levels last seen in 1993, when the US population was 260 million (20% smaller than today). There are few signs of loose mortgage lending or aggressive speculation in housing. This suggests the housing construction has room to expand as it has been below historical trends for several years in a row now. In summary, we believe that stock market sentiment has clearly gotten ahead of the facts about the economy.



Investors are running scared and pricing in a sharp slowdown in the US economy. The weakness in stock prices has been most pronounced in cyclical industries: housing, banking, auto and the industrials. Many investors still have scars from the 2008 recession when these sectors were hit incredibly hard. We believe that investors are in effect fighting the last war and projecting their experiences from 2008 onto today's reality. Despite the prevalent fears, consumers are in the best financial health in a generation, with debt service payments as a % of disposable income at generational lows. There are far fewer excesses in the general economy than in 2006 – suggesting that the current economic expansion, while long by historical standards, can continue. Australia has not had a recession in twenty-eight (28) years. Poland has not had a recession in twenty-five (25) years. There is no law of nature that suggest economic expansions must die of old age.

Many people claim to be long-term investors – that is until they experience one bad quarter. The truth is that most investors value companies with a myopic focus on next quarter's earnings. For the truly long-term investor a weakness in stock prices is a blessing in disguise because it's an opportunity to accumulate shares at more favorable prices. Several of our portfolio companies are enjoying strong earnings and buying back shares, as a result we favor low prices in the short-term, despite the impact this has on our portfolio results. Long-term investors benefit more if stock buybacks are done when share prices are low.

Our performance year-to-date has been personally disappointing. The recent market turmoil is unpleasant, and short-term losses are painful, but it is times like these that reveal who the importance of having a disciplined investment process and execution. Our process conviction remains intact and we continue to vigilantly search for new additions to our portfolio. While the "blood may not be in the streets", the time to invest is now, when prices are low, sentiment is bleak, and CNBC airs "markets in turmoil" segments.

We have welcomed several new LPs to our fund in recent months and received follow on investments from existing partners. We thank you for your vote of confidence.

If you have any questions about our investment process or our portfolio companies, please don't hesitate to reach out. As always, we welcome the opportunity.

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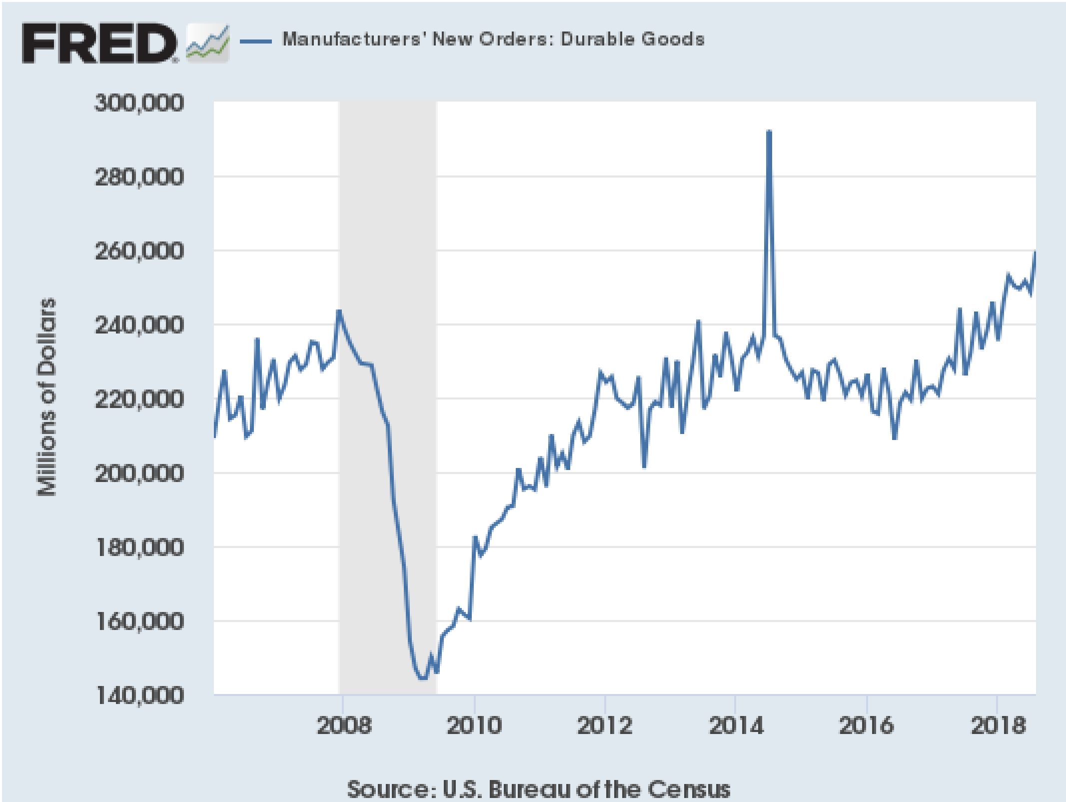
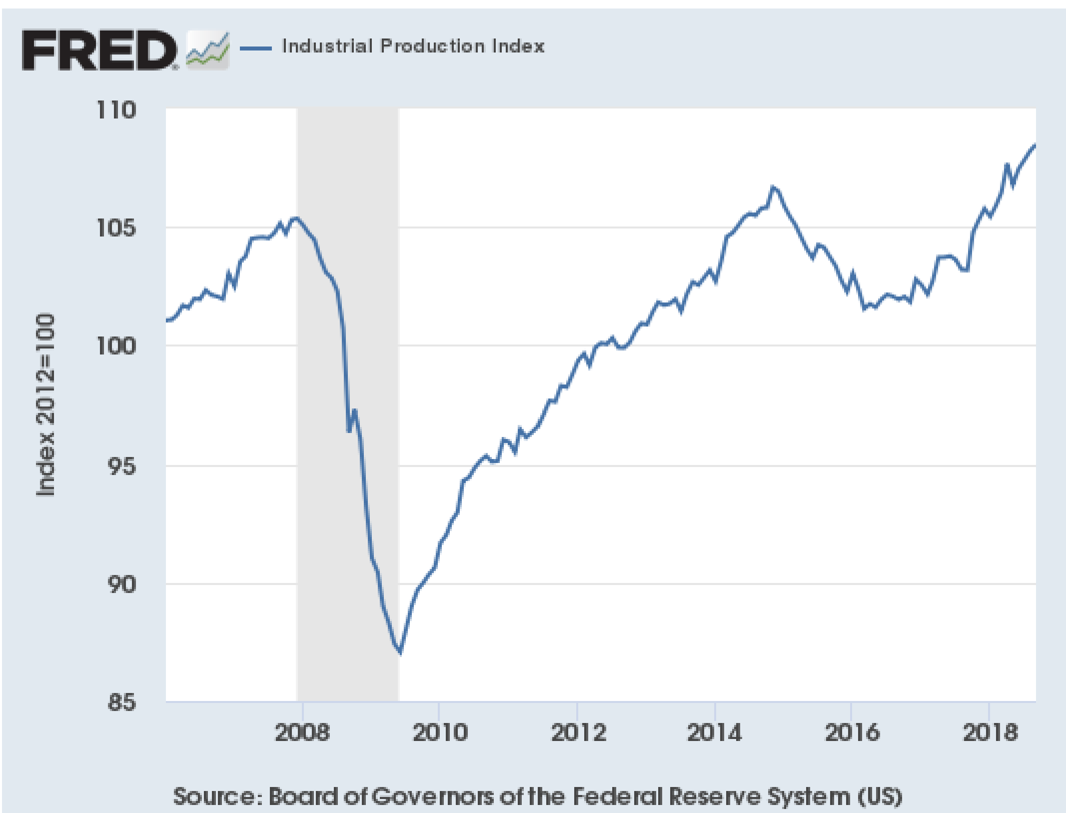
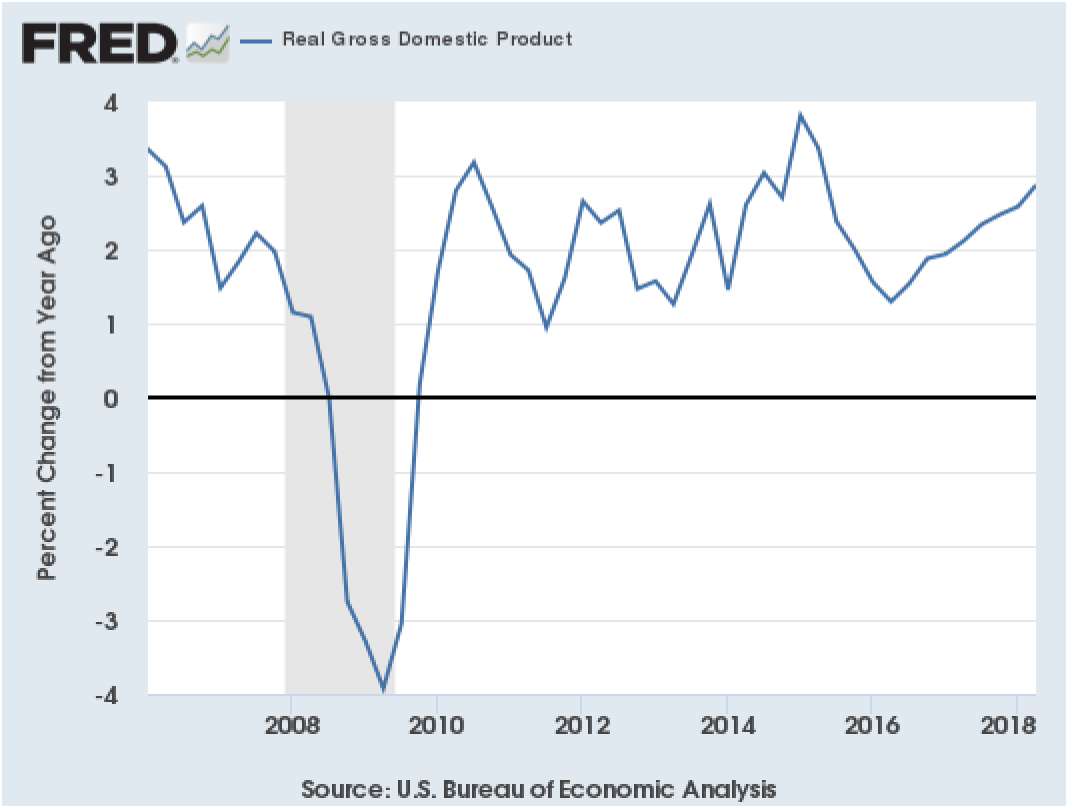
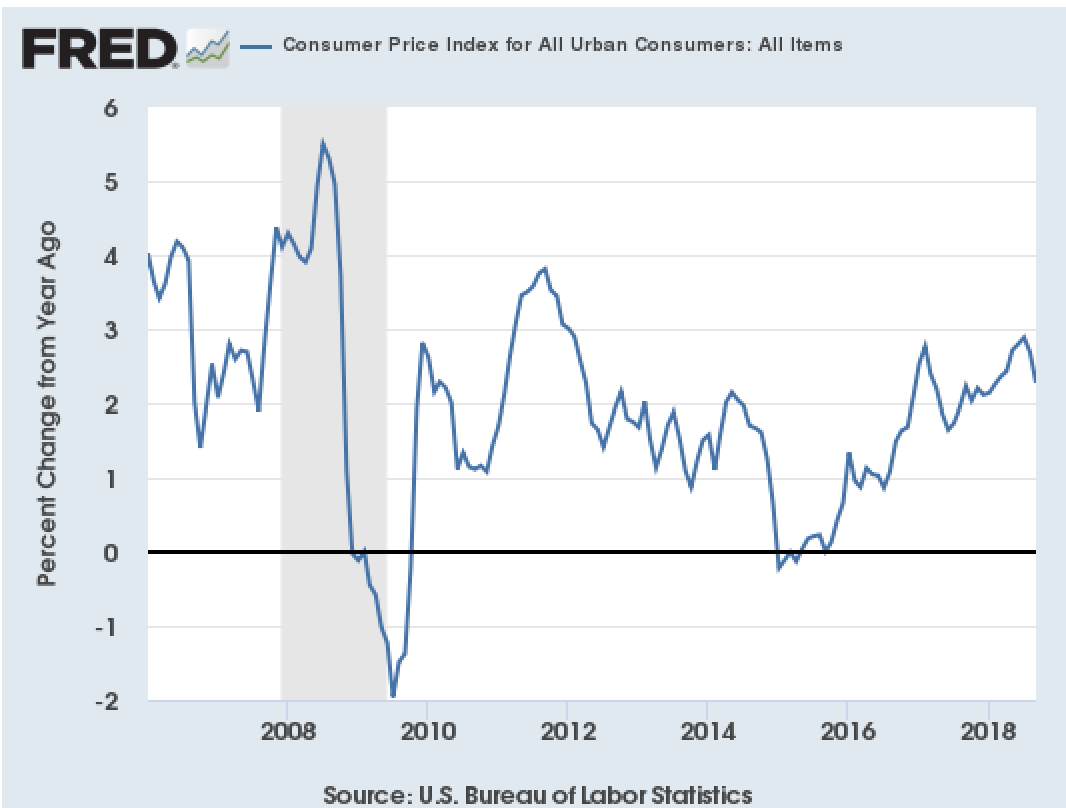
Appendix – Economic Indicators

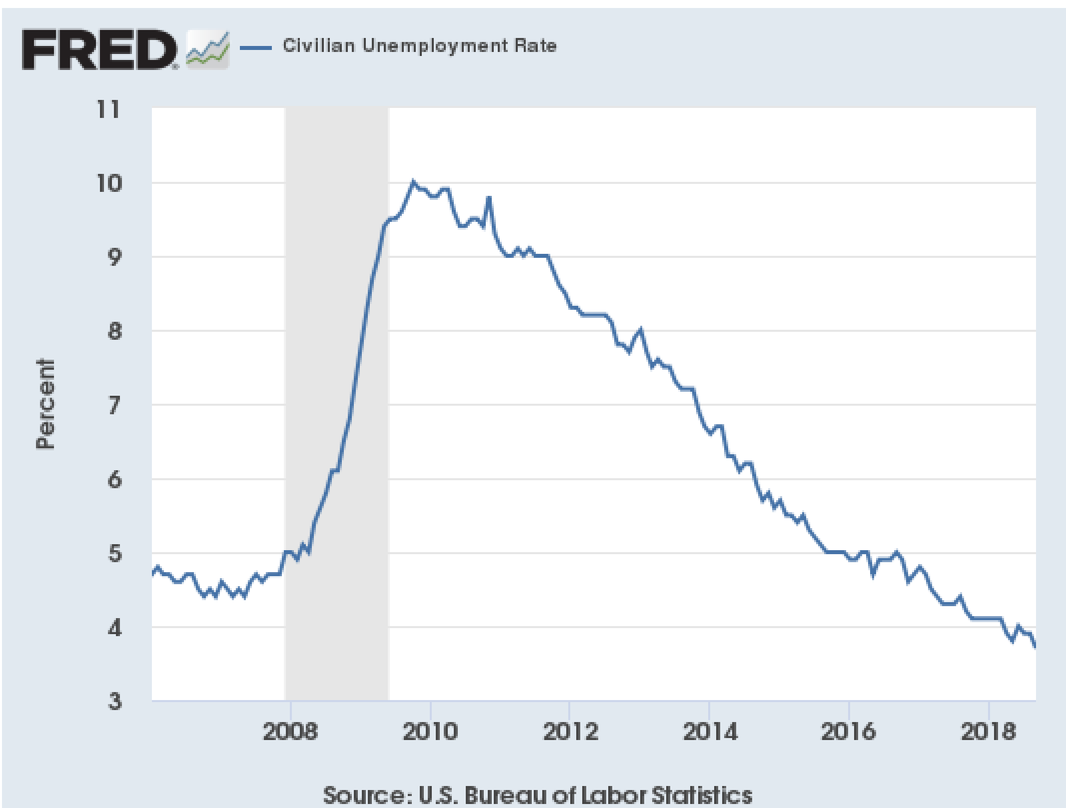


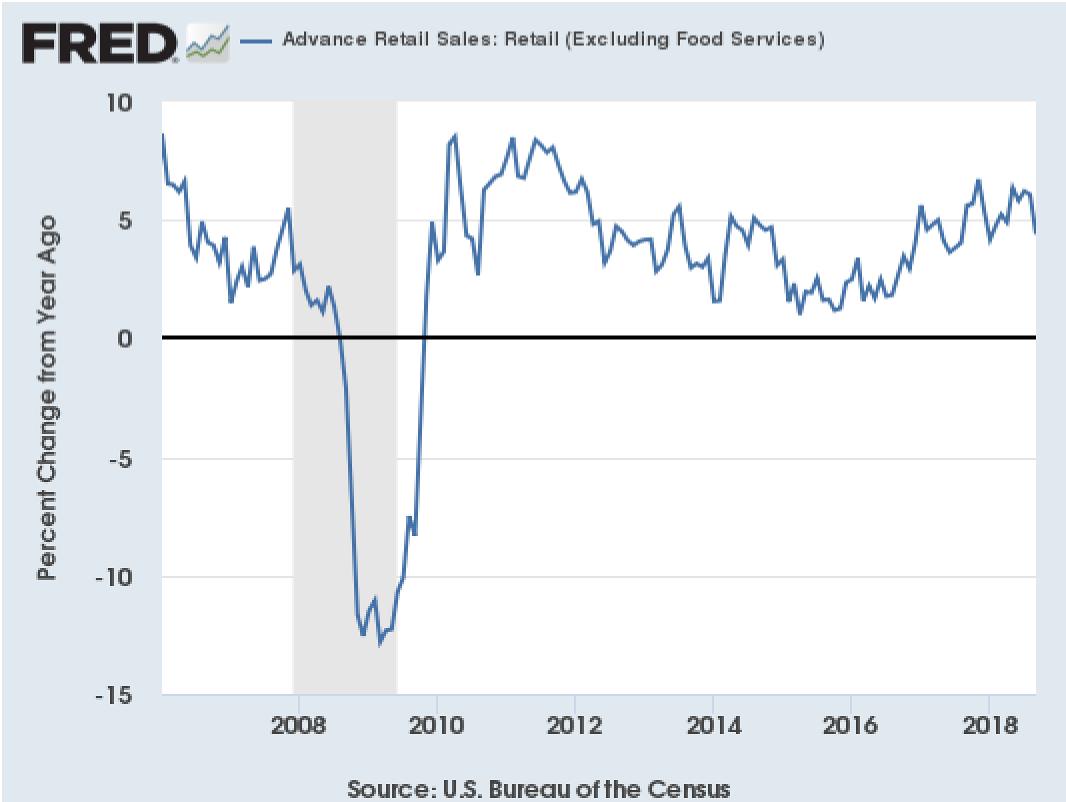



FRED
Real Gross Domestic Product
Percent Change from Year Ago
4
3
2
1
0
-1
-2
-3
-4
2008
2010
2012
2014
2016
2018
Source: U.S. Bureau of Economic Analysis


FRED
Consumer Price Index for All Urban Consumers: All Items
Percent Change from Year Ago
6
5
4
3
2
1
0
-1
-2
2008
2010
2012
2014
2016
2018
Source: U.S. Bureau of Labor Statistics

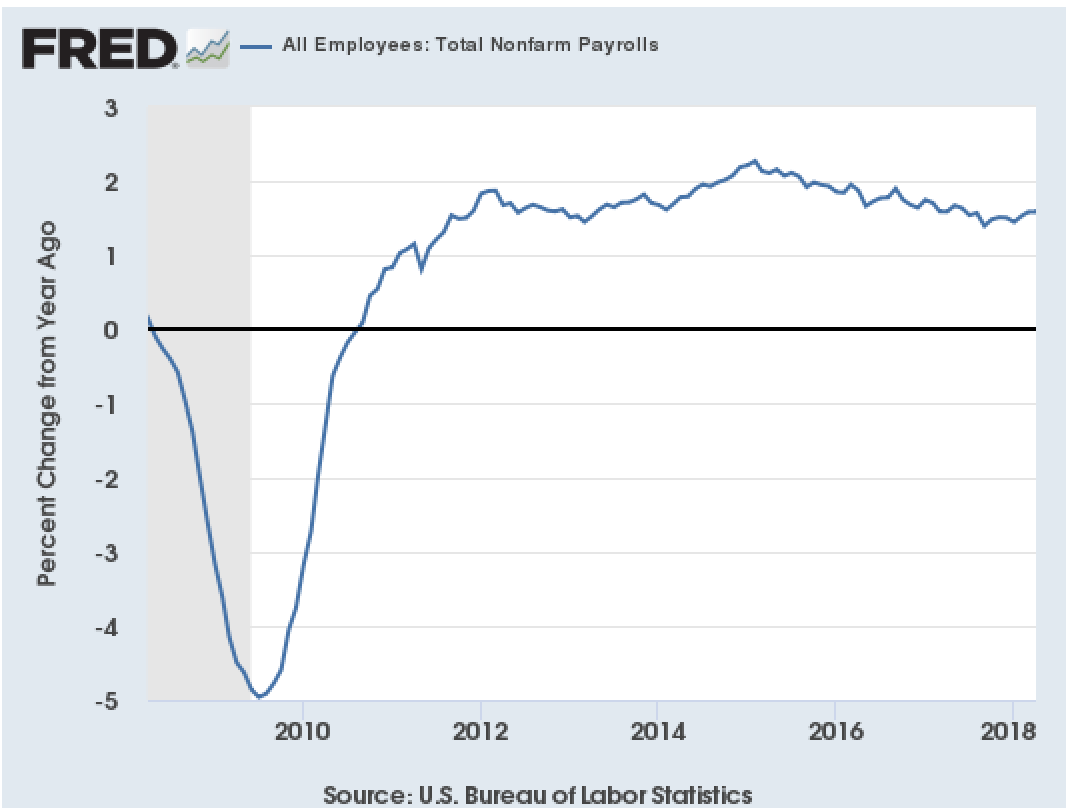

FRED
St. Louis Fed Financial Stress Index
Index
6
5
4
3
2
1
0
-1
-2
2008
2010
2012
2014
2016
2018
Source: Federal Reserve Bank of St. Louis

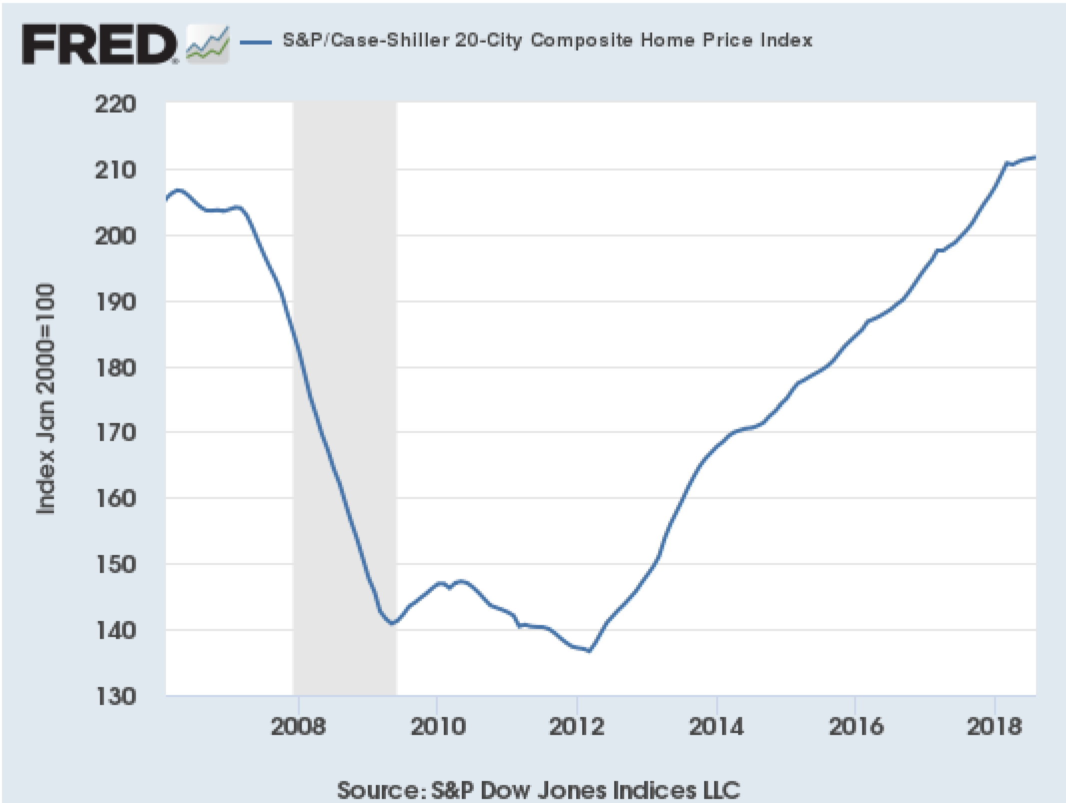

FRED
Civilian Unemployment Rate
Percent
11
10
9
8
7
6
5
4
3
2008
2010
2012
2014
2016
2018
Source: U.S. Bureau of Labor Statistics

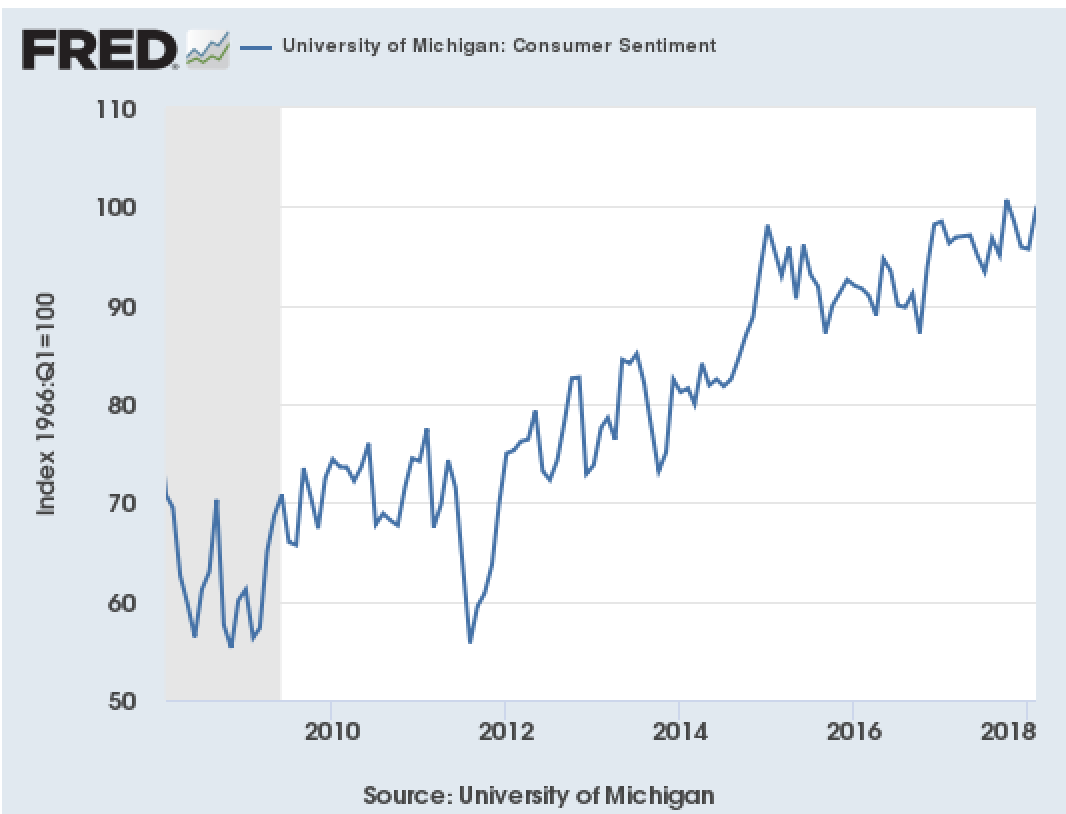

FRED
Advance Retail Sales: Retail (Excluding Food Services)
Percent Change from Year Ago
10
5
0
-5
-10
-15
2008
2010
2012
2014
2016
2018
Source: U.S. Bureau of the Census

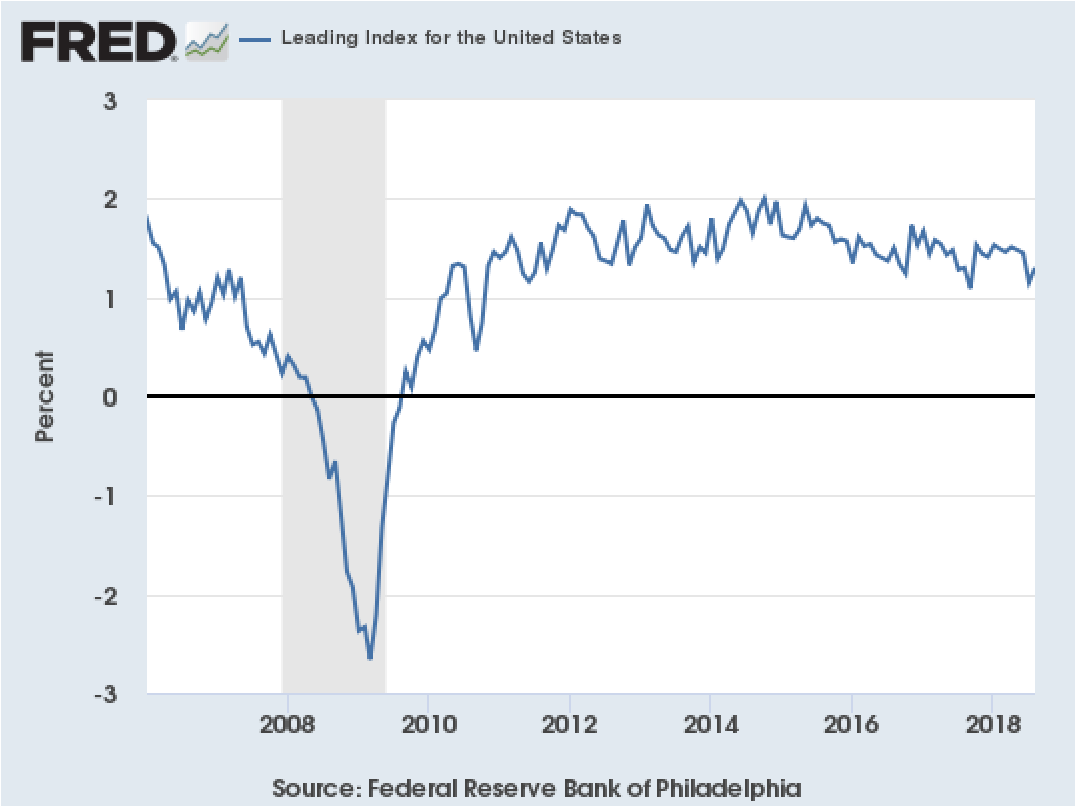

FRED
Light Weight Vehicle Sales: Autos and Light Trucks
Millions of Units
19
18
17
16
15
14
13
12
11
10
9
2008
2010
2012
2014
2016
2018
Source: U.S. Bureau of Economic Analysis

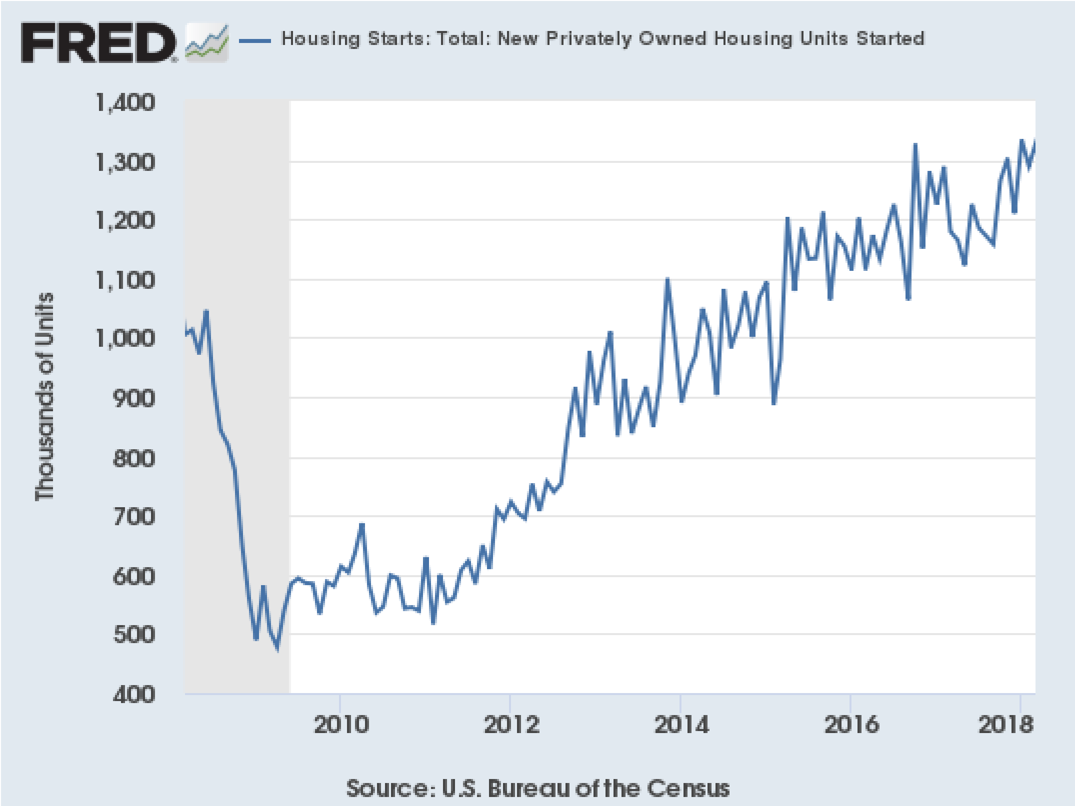

FRED
Personal Consumption Expenditures
Percent Change from Year Ago
7
6
5
4
3
2
1
0
-1
-2
-3
-4
2008
2010
2012
2014
2016
Source: U.S. Bureau of Economic Analysis


FRED
All Employees: Total Nonfarm Payrolls
Percent Change from Year Ago
3
2
1
0
-1
-2
-3
-4
-5
2010
2012
2014
2016
2018
Source: U.S. Bureau of Labor Statistics


FRED
S&P/Case-Shiller 20-City Composite Home Price Index
Index Jan 2000=100
220
210
200
190
180
170
160
150
140
130
2008
2010
2012
2014
2016
2018
Source: S&P Dow Jones Indices LLC


FRED
University of Michigan: Consumer Sentiment
Index 1966:Q1=100
110
100
90
80
70
60
50
2010
2012
2014
2016
2018
Source: University of Michigan


FRED
Leading Index for the United States
Percent
3
2
1
0
-1
-2
-3
2008
2010
2012
2014
2016
2018
Source: Federal Reserve Bank of Philadelphia


FRED
Housing Starts: Total: New Privately Owned Housing Units Started
Thousands of Units
1,400
1,300
1,200
1,100
1,000
900
800
700
600
500
400
2010
2012
2014
2016
2018
Source: U.S. Bureau of the Census