LRT
CAPITAL MANAGEMENT

THE VISION TO SEE
ECONOMIC MOATS

January 6, 2019

December 2018 - Performance Update

Dear Friends & Partners:

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

We are disappointed by our December results, but remain committed to our long-term investment strategy. Many people talk about being long-term investors, but it is in times like these that investor's nerves are truly tested. Despite the market turbulence, we remain disciplined in the execution of our investment process. We believe that our December results are due to extreme short-term factors that do not accurately reflect the value of our underlying portfolio investments.

We do not invest with a thirty-day time horizon. While our December results are disappointing we have not lost our conviction in our portfolio companies. We see every reason for the value of our investments to bounce back in the months ahead. It is important that you share our strong conviction – especially in volatile periods like these. To that end, let me put the events of the past year in context, give you a sense of what we are doing to make sure a year like this never happens again and how the Partnership is positioned to generate strong returns in the year ahead.

Nowhere to Hide

Stock markets worldwide turned sharply lower during the month of December after realizing that President Trump's "trade truce" was merely a postponement, and that the same hardliners, headed by Robert Lighthizer, would be negotiating the deal. The markets took another sharp turn lower after the Federal Reserve raised interest rates and signaled it will continue raising rates in 2019, albeit foreseeing a need for only two more rate hikes, down from three previously. Market participants were expecting a much more "dovish" Federal Reserve and a pause in interest rate increases. Investors reacted badly and sold everything that was not nailed to the floor, with the S&P 500 falling more than 10% in five days. This indiscriminate selling resulted in the second worst December (as measured by the S&P500) in recorded stock market history, the only worse one having occurred in 1931 during the Great Depression. Secondly, December constituted the worst monthly return for the stock market since February 2009 – during the Crash of 2008/2009. Finally, Q4 2018 was one of the worst quarters in stock market history. Only Q4 of 2008, the crash of 1987 and a few years during the Great Depression were worse. We believe the low market liquidity which is common during the Christmas Holidays served to exacerbate the declines as investors were desperate to exit their positions – regardless of price. Several articles by the WSJ also highlighted the role that automated algorithmic trading may have contributed to the speed of the decline.

In 2018, US corporate earnings rose an estimate 26.1% (estimated because Q4 2018 numbers are yet to be reported), but the stock market's valuation had contracted by even more, resulting in negative total return for the year. 2018 was the worst year for the US stock market since the Great Recession of 2008, but in some ways, it was even worse than in 2008. During the year there was also nowhere to hide – there were no asset classes that provided a positive return. This is truly shocking. Our portfolio strategy is to balance our investment in stocks with an investment in long term US Treasuries – a strategy that historically would have dramatically reduced volatility and shielded us from many shocks. In 2008, while stocks declined, bonds rose sharply. In 2013, when bonds fell, stocks rose sharply. In 2018, every asset class delivered negative returns: US Large Caps, US Small Caps, European Stocks, Emerging Market Stocks, Preferred Shares, High Yield Bonds, Investment Grade Bonds, Long Term Treasuries, TIPS, Emerging Market Bonds, REITs, Gold and Commodities. Furthermore, every market in the world, as measured by its MSCI total return index delivered a negative return in 2018 – with the "best" performer, Brazil delivering a return of -0.5%, and the worst, Argentina a whopping -50.8%.

US stocks have delivered nominal returns of approximately 10% over the past one hundred years. Our investment Partnership has done even better since its inception. Occasionally though a year like 2018 occurs and despite my best efforts, our investment Partnership suffered. At times like these it is easy to succumb to emotions and sell in a panic. In fact, many "market experts" are now forecasting that prices will go down even further, simply because they have been going down over the past few weeks. It is important to understand that these forecasts have absolutely no predictive power. Extrapolating the future from the past few weeks is a road to folly. Simply put: looking only at prices is not investing. We remain committed to our long-term strategy. We will not join the crowd in selling stocks, simply because prices are falling. In fact, we are inclined to do the opposite: buy when others are fearful and panicking.

Average air temperatures have been declining in the Northern Hemisphere over the past few months. It would be a mistake to forecast a new ice age is coming because of this. In fact, as even a child knows, quite the opposite is true: we are in the middle of winter and in a few weeks the temperature will rise again. As such, it is a mistake to extrapolate the stock market action of the past month and predict that prices will keep falling simply because they have been falling in the recent past. Just as surely as Spring follows Winter, so will the seasons change in the stock market.

The Road Ahead

Our 2018 results were negatively impacted by our use of leverage. During the year, we modestly reduced our leverage from x2.1 to x1.75. We believe that the resulting reduction in volatility will serve to enhance our overall investment process.

Investing is about **future** returns – and we are very optimistic about our prospects for the coming year. We have not sold any investment positions over the past three months. We don't own any financial companies or banks. We don't own junk bonds. We don't own highly leveraged companies. We don't own companies that sell "discretionary" products or services that can be easily deferred during an economic slowdown. We don't own speculative stocks. We don't own any companies without strong growth prospects. What we do own is a portfolio of companies with strong competitive advantages, long growth prospects and management teams capable of executing on these opportunities. We are confident about the prospects of the business we have invested in. At LRT we are fundamentally driven investors – we understand the businesses we invest in and as a result have the conviction to hold them through periods of market turbulence. All our portfolio companies are strong and performing extremely well.

We believe that the worst of the stock market decline is likely over. Aggregate purchases by company insiders have reached the highest level in a decade indicating that insiders are confident about the future. Many of our portfolio companies are also repurchasing their own stock – something that will benefit long-term shareholders. The economy is growing. Interest rates are not going anywhere. The valuation of the S&P500 is below its long-term average. If you don't invest in stocks under the current circumstances, you will never invest. The next few months can still be volatile, but we believe that in a year we will look back at this point in time as having been a sound buying opportunity. History is on our side. After a terrible quarter like the one we just experienced, the S&P500 has on average been up 31.9% in the following year, 72.7% in the following three years, and 129.7% in the following five years.

"Risks" are currently to the upside. Treasury bills offer a return of 2.33%, 10-Year Bonds yield 2.55%, and the S&P 500 offers an "earnings yield" of 6.94%. What's more, the S&P 500 represents a claim on real assets, meaning that corporate earnings will rise over the long term at least at the rate of inflation. US bonds on the other hand are nominal assets – their returns will be diminished by inflation over time. In the current environment stocks are very attractive – because they reflect a deep pessimism about the future of the economy and corporate earnings. We believe that such pessimism is unwarranted – long term investors should be buying equities. Our Partnership is doing just that.

Now is the time to invest. If you have been on the fence about increasing your investment in our Partnership – the recent decline in stock market valuations is an excellent opportunity to double down. Lines are open, and operators are standing by.

As also, I look forward to answering your questions.

Lukasz Tomicki

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