April 1, 2019

March 2019 – Performance Update

Dear Friends & Partners:

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

Our investment partnership experienced another positive month. We are pleased with the results of the first quarter of 2019 but urge you to not extrapolate them for the rest of the year – we believe there is going to be significant volatility in the months ahead. Our top equity positions at the end of the month are AutoZone, Inc. (AZO), Danaher Corp. (DHR), Colliers International Group Inc. (CIGI), Ryanair Holdings plc (RYAAY) and NVR, Inc. (NVR).

Ryanair is a new position, which we established during the month, replacing a long time holding Booking.com. We have long been fans on Michael O'Leary and the Ryanair business model. The shares are currently "on sale" due to a host of temporary factors that are depressing profit margins. We foresee both revenue growth and margin expansion at the company in the near future and expect the stock to follow the improving business results. Look for a video update on Ryanair in the next few days.

An Economic Update

For many months, we have been writing about the flattening yield curve and the likely upcoming inversion. That day has arrived. As we type these words, the 10 Year Treasury yields approximately 2.43%, lower than the 1-month bill at 2.47%. The yield curve is now clearly inverted with short term interest rates above all maturities up to 10 years. Historically, a yield curve inversion has preceded a sharp economic slowdown by twelve to eighteen months. Economic slowdowns have in turn been correlated with bear markets. Should we therefore sell everything and pack up our bags?

Our answer is a resounding: no. Yield curve inversions have been a reliable precursor to recessions, but what many people forget is the huge stock market gains that have often occurred **after** the yield curve inverted and **before** the recession started. In 1989, the gain in the S&P500 from the day of the inversion to the subsequent market peak was +43%. In 1998 it was +55%, and in 2006 it was +22%. Will history repeat itself or will it merely rhyme? Is the current environment analogous to 2006 or 1998? We don't pretend to know. Therefore, while we believe that a macro economic slowdown is likely, we make no attempt to time short term market moves.

How will you feel if a 2008 scenario repeats itself? How are you going to protect your capital? Instead of trying to time short term market moves, we are prepared for an economic slowdown through the quality and durability of the businesses that we own. The clear majority of our portfolio companies have highly predictable and recurring revenues generated from a substantial **installed base** of customers. We believe investors should think of an "installed base" not only in the strict literal sense, but also figuratively. AutoZone sells auto parts – a non-discretionary purchase if your car is out of order. Danaher sells many consumables to a large installed base in its molecular testing business. Moody’s and S&P Global, have an “installed base” of corporate debt that will need to be refinanced. Sherwin-Williams sells coatings into a large installed base of buildings that need repainting. A.O. Smith, Watsco, Inc. and Pool Corp sell equipment into a large installed base of water heaters, HVAC and pools, respectively. Fastenal sells industrial products through a large vending machine business and customer on-site presence. T.J. Maxx has an “installed base” of die-hard customers who love the treasure-hunt shopping experience the company offers and visit the store an average of eight times per year. Most of the companies in our portfolio sell frequently purchased items that are necessities or near necessities, and we expect their sales and profitability to be less affect than the average company in the S&P 500 in the event of a recession.

Is a repeat of 2008 the most painful scenario you can imagine? What if instead of falling, like every CNBC commentator is predicting, the market rises instead? What if the market continues to rise, as history suggests it often does? In fact, the average stock market gain from the moment the yield curve inverts to the ultimate market top is over 30%. How will you feel when you miss this gain? How will you feel if you sell now and then watch the market go up 10%, 20%, 30% or even 50% as it did between 1998 and 2000? You must tune out the noise. Trading on emotions and hunches can be disastrous, because the record of market pundits is not great – see the appendix for some predictions made by market commentators in the past. We don’t try to dance in an out of the market and neither should you. Think of the people who sold in 2008 because they “knew” prices will go a lot lower. They are still waiting. Will they ever get back into the market? Or will they regret their decisions for the rest of their lives?

As Pogo has said, “we have met the enemy and he is us.” Similarly, studies suggest that the biggest obstacle to investment success maybe yourself. Investors are constantly trying to predict the unpredictable, such as short-term market movements or quarterly earnings. You must recognize that not investing in a sound investment strategy, simply because you believe the market is a little “high” at present, is the same as making a prediction that it will decline in the near future. We don’t know anyone who can reliably predict the market top, sell at near the top and get back in near the bottom without missing the rebound. If despite all the evidence, you still want to practice market timing, feel free and good luck – after all it is your money. But we will not be doing it for you.

You need a clear and disciplined investment process for protecting capital and generating performance. At LRT we have a well-defined process that is repeatable, predictable and consistently executed. Our process allows us to identify high quality companies (those with a moat, growth opportunities, and management with good capital allocation skills), and gives us the discipline to hold them for the long term. Our investment results are a testament to the efficacy of our process.

We look forward to discussing it in more detail with you.

Lukasz Tomicki

Appendix: The Bubble Basket

The companies in the Bubble Basket are: Benefitfocus, Inc. (BNFT), Box, Inc. (BOX), Coupa Software Incorporated (COUP), salesforce.com, inc. (CRM), Cornerstone OnDemand, Inc. (CSOD), Tableau Software, Inc. (DATA), DocuSign, Inc. (DOCU), Domo, Inc. (DOMO), Eventbrite, Inc. (EB), HubSpot, Inc. (HUBS), Instructure, Inc. (INST), LogMeIn, Inc. (LOGM), Medidata Solutions, Inc. (MDSO), New Relic, Inc. (NEWR), ServiceNow, Inc. (NOW), Anaplan, Inc. (PLAN), Qualys, Inc. (QLYS), RingCentral, Inc. (RNG), RealPage, Inc. (RP), Rapid7, Inc. (RPD), Splunk Inc. (SPLK), SVMK Inc. (SVMK), Atlassian Corporation Plc (TEAM), The Trade Desk, Inc. (TTD), Twilio Inc. (TWLO), 2U, Inc. (TWOU), Veeva Systems Inc. (VEEV), Workday, Inc. (WDAY), Wix.com Ltd. (WIX), Zendesk, Inc. (ZEN).

We began our Bubble Basket experiment on 3/1/2019. We assume an equally weighted portfolio and will update the portfolio's hypothetical performance each month. We expect the portfolio to underperform the S&P 500 over the next three years, with significantly higher volatility. We removed Ultimate Software, Inc. (ULTI) from the basket due to a pending takeover and replaced it with New Relics (NEWR).

During the month of March, the Bubble Basket returned +0.63%, compared to +1.81% for the S&P 500.

Appendix: The Market vs. Pundits

Nov. 2009 – Barron’s – “The Easy Money’s Been Made”

Dec. 2010 – Morningstar – “The Easy Money Has Been Made”

Nov. 2011 – MarketWatch – “The Easy Money Has Already Been Made”

May. 2012 – TheStreet – “The Easy Money Has Already Been Made”

Aug. 2012 – Paul Farrell – “The real crash is dead ahead”

Nov. 2012 – Marc Faber – “Prepare for a massive market meltdown”

Mar. 2013 – Chris Martenson – “The market will fall 60%”

Apr. 2013 – Rober Wiedemer – “The market will fall 90%; unemployment 50%; inflation over 100% per year”

Dec. 2013 – Morningstar – “The Easy Money Has Been Made”

Oct. 2014 – Barron’s – “The Easy Money Has Been Made in Stocks”

Jul. 2015 – Ron Paul – “Stocks are in a bubble and will crash”

Sep. 2015 – Carl Icahn – “Danger Ahead”

Dec. 2015 – CNBC – “No More Easy Money”

Jan. 2016 – RBS – “Sell everything, brace for cataclysmic year”

Apr. 2016 – Globe and Mail – “The Easy Money Has Been Made”

Jun. 2016 – Marc Faber – “epic decline ahead, stocks to plummet 40%”

July 2016 – Jeff Gundlach – “Sell everything”

Nov 2016 – Paul Krugman– “Very probably looking at global recession, with no end in sight”

Aug. 2017 – Ron Paul = “50% stock market plunge conceivable, as soon as October”

Nov. 2017 – Howard Marks – “The Easy Money Has Been Made”

LRT Capital Management, LLC
401 Congress Street, Suite 1540
Austin, TX 78701
Office: +1 512 852 4320
www.lrtcapital.com