THE VISION TO SEE ECONOMIC MOATS

May 1, 2019

April 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 driven by strong gains across the portfolio. We are pleased with the results of the first four months 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), Ryanair Holdings plc (RYAAY), Danaher Corp. (DHR), NVR, Inc. (NVR) and Colliers International Group Inc. (CIGI).

At the margin, we were net sellers of stocks during April. This is a result of our risk management strategy, as many of our investment positions appreciated sharply over the past few months. The selling we engaged in during the month is not a prediction on the near-term direction of the market. Our actions during April were the opposite of those in December of 2018, when we were net buyers of equities. Should a significant selloff in the stock market occur again we expect to be net buyers once more. As we have said in the past: we see short-term volatility as an opportunity to enhance the performance of our investment partnership.

Risk …

Stock market commentators continue to highlight the inverted yield curve and warn of an upcoming recession. At LRT, we too, believe that a recession sometime in the next eighteen months has a greater than even probability. Where we differ from others, is in our prescription for what to do in the event of a recession. We do not plan to sell our positions, engage in complex derivative trades with the intention of hedging, or pass up on promising investments due to a fear of a recession. The world is always uncertain and risky – even when the future appears clear. We believe risk management is an integral and ongoing part of any portfolio management process.

Risk management at LRT has four major parts:

1. The **operational risk** of our portfolio companies is lessened by only investing in companies with strong and growing competitive advantages (moats). If a business does not have a moat, it won't be in our portfolio.
2. The **macroeconomic risk**, i.e. the risk of a recession is lessened by only investing in companies that are price setters and not price takers. Most of our portfolio companies supply the vital necessities or near necessities of life, have high recurring revenues, are less leveraged, and less

cyclical than the average company in the S&P500. If a company has to hold a prayer session before raising prices – it is not in our portfolio.

3. The **valuation risk** is reduced by only investing in companies whose shares trade at a material discount to our calculation of their intrinsic value. We do not knowingly invest in companies whose shares are overvalued with the expectations of simply selling them off at an even higher price, i.e. the "greater fool" investment school.
4. The **volatility risk** is reduced through our unique portfolio construction process. First, we have a proprietary position sizing process which overweighs low-volatility stocks and stocks with low-correlations to the overall market. Secondly, we hold a fixed amount of volatility risk in long dated US Treasuries. We do this because Treasuries tend to be negatively correlated to equities, thus when our equity positions decline, the bonds tend to offset this. The volatility risk exposure to Treasuries is fixed, which means that as the realized volatility of equities rises, our dollar exposure to Treasuries rises and our equity exposure falls – in other words it is the relative volatility of the two asset classes that drives their dollar allocation. Third, we rebalance our portfolio on a monthly basis and mechanically trade to meet our target risk exposures for each position – this means we will be buying stocks after they decline in value and selling stocks somewhat after they have risen. Taken together, these techniques meaningfully reduce our portfolio volatility while enhancing long term returns.

We believe that risk management is the most crucial part of any investment process and that we are well prepared for an economic slowdown and bear market – whenever it may come. We do not fear a market correction and as long-term investors neither should you.

… and Reward

Risk management is important, but it is not everything. We could reduce our risk to zero tomorrow by selling all our positions. That would reduce our short-term risk to zero but would guarantee a loss of purchasing power over the long run as inflation eats up the value of nominal assets every day. Paradoxically, taking no risk in the short term is a guarantee of long-term financial failure. Risk must always be balance with a focus on reward. Why does forecasting a crisis or collapse sound newsworthy and "smart" while saying that the economy will probably continue to expand at a moderate pace just sounds lame? Bearish views and negative forecasts dominate the financial media, but they are at odds with history.

Stocks have been the best asset class in the history of investing, rising an average of approximately 10% annually over the past 100 years (7% after inflation). Historically, the stock market has risen in more than two-thirds of the years. In other words, the stock market rising with indexes making new all-time highs is a fairly common state of the world. While there is always, something to fear and occasional big shocks happen, the world is steadily getting better each day. Every day, every month and every year, companies are becoming slightly more productive and the world advances. Over time these tiny gains translate into enormous increase in productivity, purchasing power, improvements in living standards and gains for investors. In the long history of American capitalism, the optimists have triumphed. Few, if any, great fortunes have been made by betting against America.

The history of the world is the history of continued improvement. It is important to remind ourselves that every day, someone, somewhere is working to improve things. Who could have foreseen that Chinese social media "influencers" would become a $9 billion annual industry? (https://www.scmp.com/tech/big-tech/article/3001599/how-chinas-kols-convert-fans-sales-creating-nearly-us9-billion). There is no upper boundary on how good things can get, how big the economy can become or how far corporate profits can rise. In investing, over the long-term, “what goes up”, does not necessarily come down. Even in the most mundane of areas, such as traffic intersections, there are continual improvements – such as the Diverging Diamond Interchange (see https://divergingdiamond.com/ for more details; as a resident nearby a recently opened DDI I can attest to its efficacy – as counterintuitive as it first appears). We cannot foresee much less forecast all the future improvements in productivity and growth that is ahead.

More money has been lost in predicting and anticipating market corrections then in the corrections themselves. Much of these losses are in the form of missed opportunities – all the investment you didn’t make because of short term fears about the economy. The longer you wait to invest, the larger your opportunity cost becomes, as the stock market rises over time. People who sold in 2008, in the anticipation of buying at even lower prices, are still waiting – and they may never buy again in their lifetimes. Every year you pass up investing simply because you are afraid of an adverse short-term market move, inflation destroys a bit of your wealth. By passing up on investing you guarantee yourself a loss of purchasing power in the long run. Foregone profits are the most insidious type of losses because they do not show up directly in your P/L. At LRT we have a clear, repeatable and disciplined process that enables us to invest with high conviction. We are always vigilant and on the lookout for threats to portfolio performance. But we will not be swayed by the siren calls of the TV prophets of doom. And neither should you.

The Most Important Thing: Act Now

When it comes to macroeconomics there is one figure whose importance dwarfs all others: the growth rate of GDP-per-capita. Without GPD-per-capita growth nothing else matters. Not equality, not the environment, not healthcare. It is GPD-per-capita and its cousin, productivity, that determines the long-term trajectory of nations. Over the long-term, even small changes in how fast you grow productivity as a nation will compound to have enormous consequences.

The same holds true in investing. Would you rather have a penny that doubles every day for 30 days or $10 million dollars today? How much does a penny doubling 30 times turn into? The outcomes of exponential growth are hard to conceptualize, and the impact of long-term compounding is often lost on us. The longer the holding period, the greater the impact that a change in the rate of return will have on your ending wealth. Therefore, the most important question over the long term is how fast you can compound your capital. The impacts of even small changes on long-term outcomes are staggering. The table below illustrates the ending wealth of investors who compound at different rates. Careful readers will note that our investment partnership has generated returns greater than those in the table that follows.

Ending wealth starting with $100,000 investment

Rate of return	5 Years	10 Years	20 Years
10.0%	$161,051	$259,374	$672,750
15.0%	$201,136	$404,556	$1,636,654
20.0%	$248,832	$619,174	$3,833,760
30.0%	$371,293	$1,378,585	$19,004,964

Whatever goal you are saving for, if you are at risk of falling short of your objective, there are only three things you can do: 1) reduce your expectations; 2) save more; 3) increase your returns. Unsurprisingly, to most of us, the third option is preferable. It is tempting to try to guess short-term market moves or to be afraid of investing because the stock market is near all-time highs. It can be daunting to consider a twenty-year investment horizon, when pundits on TV tell you a recession will hit any day. But the record of TV pundits in predicting recessions and stock market corrections is terrible, so you should not be deterred from investing because of it. As the old Chinese proverb say, “The best time to plant a tree was 20 years ago. The second-best time is today.”

Stocks are not just pieces of paper to trade, but fractional shares in businesses. Exceptional stock performance comes from exceptional **per-share** business performance. In the long run, investment returns closely mirror the returns of the underlying businesses, overwhelming any short term returns from market timing. We are therefore first and foremost business analysts at LRT. Over the past 30 years, one could purchase a random selection of companies operating in the coatings, medical devices, payment networks, cell phone towers, waste disposal services, business information services, airplane parts, software, specialty retailers, industrial distributors, media, or consumer staples industries – and outperformed the market by a wide margin, all because the **business** performance of these companies was superior to that of the overall market. It is our contention that this superior performance was enabled by structural characteristics, i.e. competitive advantages (moats) being more prevalent in these industries than in the economy overall. These are the industries where we continue to look for new investments.

Life and financial markets are always uncertain, but this is no excuse for being distracted by short term noise. In these times heightened of volatility and uncertainly, a well-defined and consistently executed investment strategy that enables **high conviction investing** is more important than ever. If you would like to learn more about how our investment process at LRT helps us protect capital and generate portfolio performance, give us a ring.

I appreciate your continued interest, trust and the opportunity to managed some of your hard-earned savings. As always, I look forward to answering your questions,

Lukasz Tomicki

Appendix: The Bubble Basket

We began our Bubble Basket experiment on 3/1/2019. See our February 2019 letter for more information. We assume an equally weighted portfolio and will update the portfolio's hypothetical performance each month. We posit that investors are paying too much for the glamour of fast-growing SaaS businesses and will earn subpar returns as a result. 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 takeover and replaced it with New Relics (NEWR).

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). The bubble basket is not rebalanced.

	Bubble Basket (1)	**S&P 500 Total Return (2)**	**Difference (1-2)**
March, 2019	+0.63	+1.81	(1.18)
April, 2019	+5.36	+4.09	+1.27
Since inception	+5.69	+5.97	(0.28)

Appendix: Investment Philosophy

In the past eighteen months we saw a large increase in the number of LRT Capital partners (the term we use to describe our clients). With so many newcomers, it is important that we write about our investment philosophy again.

Here are the key points:

- Exceptional stock returns come from exceptional business returns on a **per-share** basis.
- We seek to invest in high-quality companies, i.e. those possessing sustainable competitive advantages (moats), the ability to grow and reinvest capital over time, and management that excels at capital allocation.
- We only purchase companies whose shares trade at a discount to our assessment of their intrinsic value.
- It is futile to predict short-term market movements. We seek to hold our investments for as long as possible.
- The financial markets are dominated by short-term traders who see stocks as casino chips. This occasionally allows us to purchase shares in great companies at large discounts to their true worth.
- If we are right about the trajectory of the businesses we invest in, over time we will be right on the trajectory of their stock prices.

We view stock market volatility as a source of opportunity. Volatility allows us to profit by acquiring shares in superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Over the long run, stocks are the best investment asset class, but our experience has taught us that our investment process will not generate linear returns. In some years, our portfolio will outperform and in others it will generate a below average return. This is a certainty that we must accept. We are long-term investors and we do not try to dance in and out of the market.

In summary, our investment strategy can be summed up in three steps:

- Only seek out high-quality companies.
- Do not overpay.
- Do nothing – patience and discipline are the keystones to success.

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