June 4, 2019

May 2019 - Performance Update

Dear Friends & Partners:

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

Our results during the month were disappointing but they are just that: one month. Several factors conspired to produce this month's results: President Trump's trade war tweets, worsening macro-economic sentiments, and disappointing earnings reports from several of our companies. Specifically, Ryanair, our second largest holding declined very sharply during the month – a mirror image of the stock's very strong performance in April. This was driven by increasing fears of a prolonged price war in the European aviation market and soft guidance issued by the company. Ryanair reported earnings exactly in line with previous guidance, issued realistic guidance for the year ahead and announced a major stock buyback. We are **pounding the table** on Ryanair – the current confluence of events represents a rare opportunity to acquire shares in a wonderful company operating in a depressed environment and available for purchase at a valuation not seen since the 2008 financial crisis. We are delighted to see management buying back shares at these prices. We expect the stock to double in the next three years with minimal downside from these levels.

In addition, disappoint earnings from Cognizant and A.O. Smith contributed to the decline in our portfolio. A.O. Smith was also hit by allegations of fraud in its Chinese business. Both Cognizant and A.O. Smith increased their stock buybacks – something we believe makes a lot of senses given the valuations of the stocks. In both cases we view the setbacks that the companies are dealing with as temporary, and the shares as undervalued.

During the month, we continued to reduce risk and were net sellers of equities. 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). Overall, we are pleased with our results year-to-date and expect the weakness we experienced in May to be short-lived.

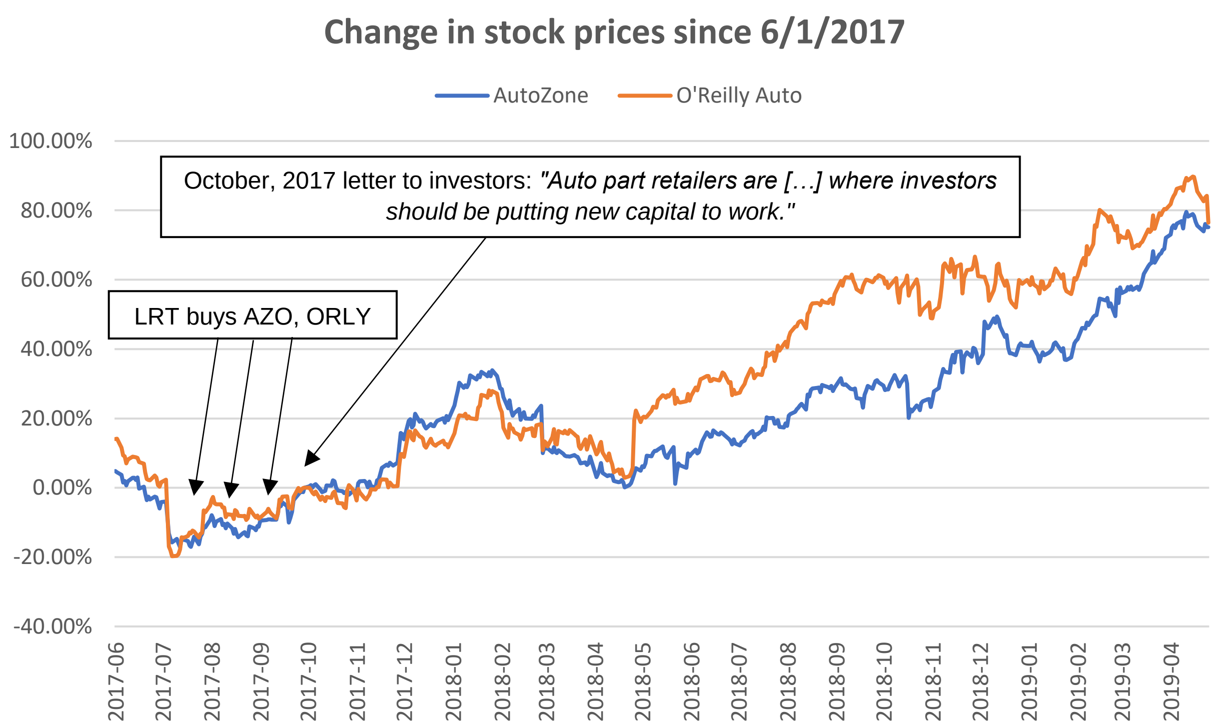
We are long term investors. We urge you to study and focus on our **investment philosophy**, not short-term results. We are consistently executing our investment process and the seeds for the results you have seen year-to-date were planted in 2018. Today we are planting the seeds for future returns. We have no idea what the next thirty days will bring but we feel confident in our investment strategy over the longer term. We have outperformed the S&P 500 by a significant margin over any rolling three-year period since inception. Our advantage is **structural** – it is the investment process and the consistent execution of our strategy that drive our outperformance.

Looking Back …

In today's letter we want to give you more insight into our investment process and its execution. At LRT, we look to invest in companies with three characteristics: a durable competitive advantage, the ability to grow and reinvest, and a management team with a strong track record of capital allocation. However, identifying a promising company is insufficient – it must also be available for purchase at an attractive price. When occasional fears about short term difficulties facing a company or industry overshadow the otherwise stellar prospects of said companies, we **act promptly and in size**. In October 2017, such a period occurred with respect to the auto part retailing sector, and we identified this opportunity in our letter to investors. Specifically, we said:

> *Both AutoZone and O'Reilly are currently trading at meaningful discounts to their historic valuations and to the market as a whole. Both companies are likely to be in business a decade from now. We view both companies as possessing significant moats, above average free cash flow and the ability to grow through consolidation. Auto part retailers are one of the very few places in today's richly valued market where investors should be putting new capital to work. You can be sure that we have acted accordingly.*
>
> *LRT Letter to Investors, October 2017*

We wrote these words after slowly buying shares in AutoZone and O'Reilly Auto over the previous three months. At the end of September, these two companies represented a little over 10% of our equity exposure. In our October 2017 letter, we disclosed our investment position. Here is what happened to AutoZone (AZO) and O'Reilly Auto (ORLY) in the following months:



Total return price series. Rebased as of 9/29/2017. Source: Capital IQ, LRT Capital Management

As seen in the chart above, both stocks have appreciated significantly over the past eighteen months. At that time, there was a strong negative sentiment towards these companies' profitability due to Amazon's attempt to increase their sales of auto parts. Clearly, our investment thesis has played out as we expected, but we want to draw your attention to two things that made this possible. First, is the process that allowed us to **identify** the opportunity and **act on it with high conviction** despite the financial press and sell-side coverage both being negative at the time. Our conviction was an outcome of our process and our deep familiarity with the auto part retailing sector – an expertise we had developed over a long period of time. We had studied the companies in the industry for several years before making our investment and have developed insights based on conversations with industry executives. We had also known that this was not the first time Amazon had attempted to increase their sales of auto parts, but because of our deep knowledge of the nature of competition in the auto parts industry, we had the conviction to invest despite the negative sentiment surrounding the industry.

Secondly, it is insufficient to simply identify an opportunity – you must have a process to **capture** and **maximize** the value of that opportunity given your risk management process. We had invested a little over 10% of our fund's assets into these two companies and <u>held this investment position</u> for over eighteen months. Our portfolio position sizing is a result of our systematic risk management process, that over-weights low volatility and low systematic risk companies. During this time period, both AutoZone and O'Reilly Auto had relatively low exposure (correlation) to the systematic risk of the stock market – their returns were mainly depended on company specific developments, not the market overall. It is this systematic investment process that gave us the conviction to hold these large positions and NOT sell despite the large rally in the stocks in subsequent months. Without a disciplined process, most investors would sell after the stocks have risen 30, 40, or 50%. They would have failed to fully capitalize on the opportunity. Would you be one of them? Would you then regret your decision as you watched the shares rally another 30%? Most investors have no process for identifying and capturing promising investment opportunities. How can you succeed in investing without a process? Do you make decisions based on your intuition? Your gut feelings? Smoke signals? Don't be fooled when someone tells you they have "trader instincts" – when someone says that, you know they are just flying by the seat of their pants.

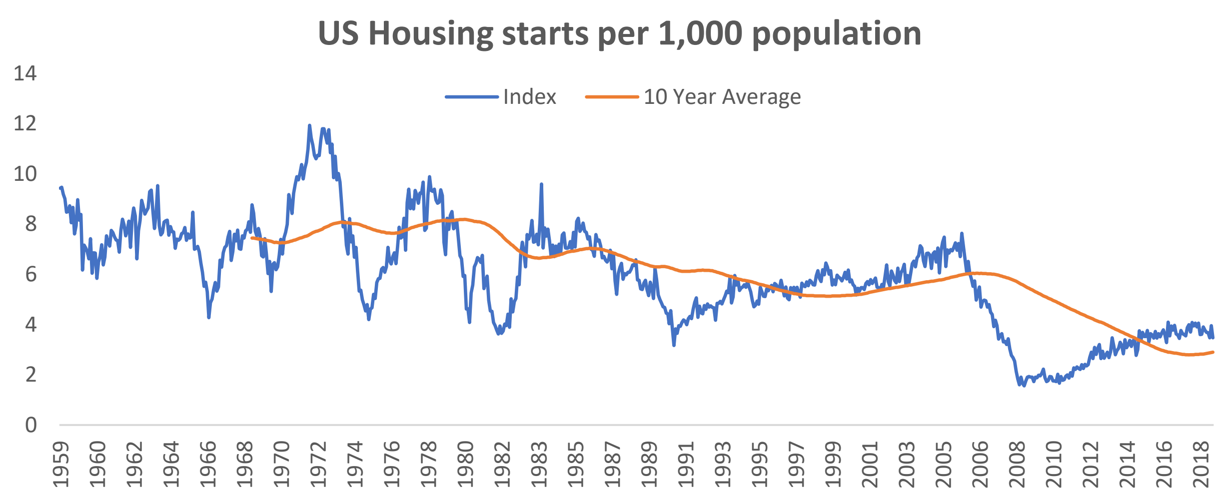
We have only recently begun to reduce our portfolio exposure to AutoZone and O'Reilly Auto – simply because the stocks have become more correlated to the overall market. Having good investment ideas means nothing if you don't capture and maximize the value of the opportunities you identify. We have a systematic investment process that enables us to invest with high conviction and fully exploit investment opportunities within a rigorous risk management framework. Our position sizing and risk management is not ad-hoc. It is a well-defined process that we can repeat **over and over again**.

… And Looking Forward

Since our investment thesis in the auto part retailers has played out so well, you might ask: where is the next big opportunity? Today, we will reveal the first of several areas where we see significant opportunities for outsized gains in the near future.

The one area of the market that has been particularly weak over the past eighteen months has been housing. We see several opportunities related to US housing and are allocating our capital accordingly. In particular, we see significant value in companies selling goods and services into an established installed base: home improvements retailing, pool construction and supplies, air-conditioning equipment, trash collection, paint and commercial real estate services. We consider these to be low-risk investments with asymmetric outcomes: their current businesses are stable and predictable, but with significant upside should the housing market strengthen – as we expect it will. In addition, many of these businesses have significant optionality for additional growth through consolidation.

Why do we believe housing will strengthen in the months ahead? Because, despite a US economic expansion that is in its tenth year, US housing construction has been shockingly weak. This underinvestment in housing is dramatic and means that there is huge pent up demand. Housing affordability remains a challenge, but unit volume has been extremely tepid, suggesting that housing is more likely to surprise to the upside in the coming months and years. The chart below tells the story succinctly: US Housing starts adjusted for population are at very low levels. What's more, the ten-year average of this metric is also at historically low levels. The United States has not been building enough housing – and this has created a huge reservoir of housing demand that will support the market. We simply do not see significant room for housing to weaken and ample room for an increase in housing construction.



Source: Federal Reserve Bank of St. Louis

At LRT, we believe that the US housing market and residential construction will strengthen. Consider the following:

1) Housing demand remains pent-up due to low levels of construction over the past decade.
2) Mortgage rates are lower than they were a year ago.
3) The price of the most important raw material, lumber, has declined by over 30% from a year ago.
4) Unemployment is at historical lows and wage increases have accelerated.
5) Debt service as % of disposable incomes in the United States remains at a generational low.

See Appendix III for additional charts.

We are currently long shares of NVR, Inc. (NVR), and exceptional home builder whose business and executive compensation practices put it in a league of its own. We first discussed our position in November 2018 – since then shares have risen by over 35%. In addition to our disclosed position in NVR, we have identified other significant opportunities in housing and housing related investments – some quite counterintuitive. We have found several attractive companies whose businesses will benefit from an upswing in the housing market and where we believe that stock prices do not accurately reflect this. All the companies we have invested in meet the LRT investment criteria: they possess sustainable competitive advantages, they have opportunities to grow and reinvestment, and they have management teams with a demonstrated track record of excellence in capital allocation.

To find out more about our investment process at LRT and specific companies that we believe will benefit from a robust housing market – give us a call.

Thank you for 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 I: 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.

Appendix II: The Bubble Basket

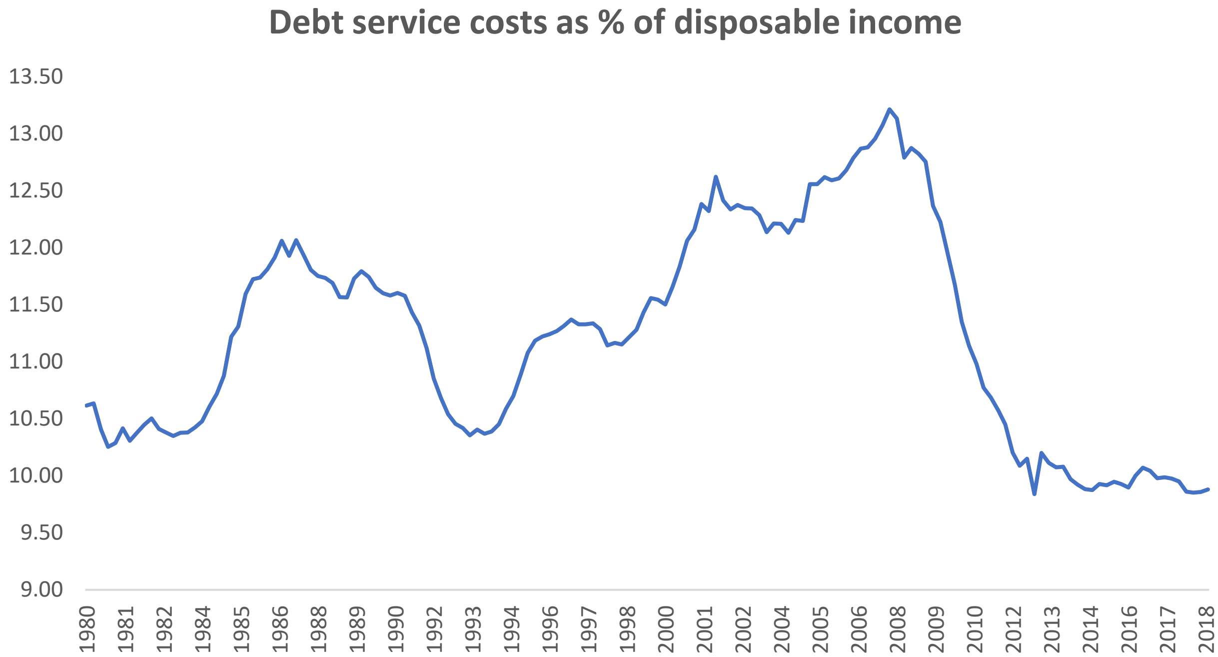
We began our Bubble Basket experiment on 3/1/2019. See our February 2019 letter for more information. We assume an equally weighted portfolio and will update the portfolio's hypothetical performance each month. We posit that investors are paying too much for the glamour of fast-growing SaaS businesses 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.

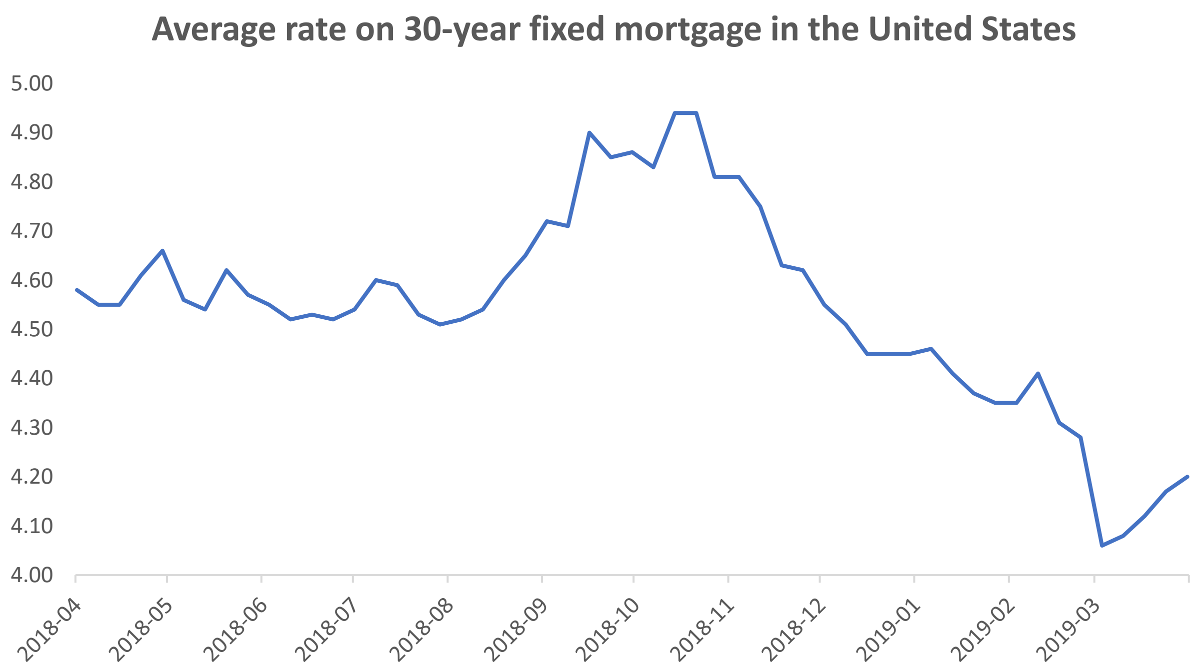
	Bubble Basket (1)	**S&P 500 Total Return (2)**	**Difference (1-2)**
March, 2019	+0.63	+1.81	(1.18)
April, 2019	+5.03	+4.09	+0.95
May, 2019	(4.37)	(6.38)	+2.01
Since inception	+1.08	(0.79)	+1.87

	Standard Dev	**Sharpe ratio**
S&P 500 Total Return	19.06%	(0.07)
Bubble Basket	18.32%	0.02
Risk free rate	2.50%	
Months	3	

Appendix III: Supplemental Charts

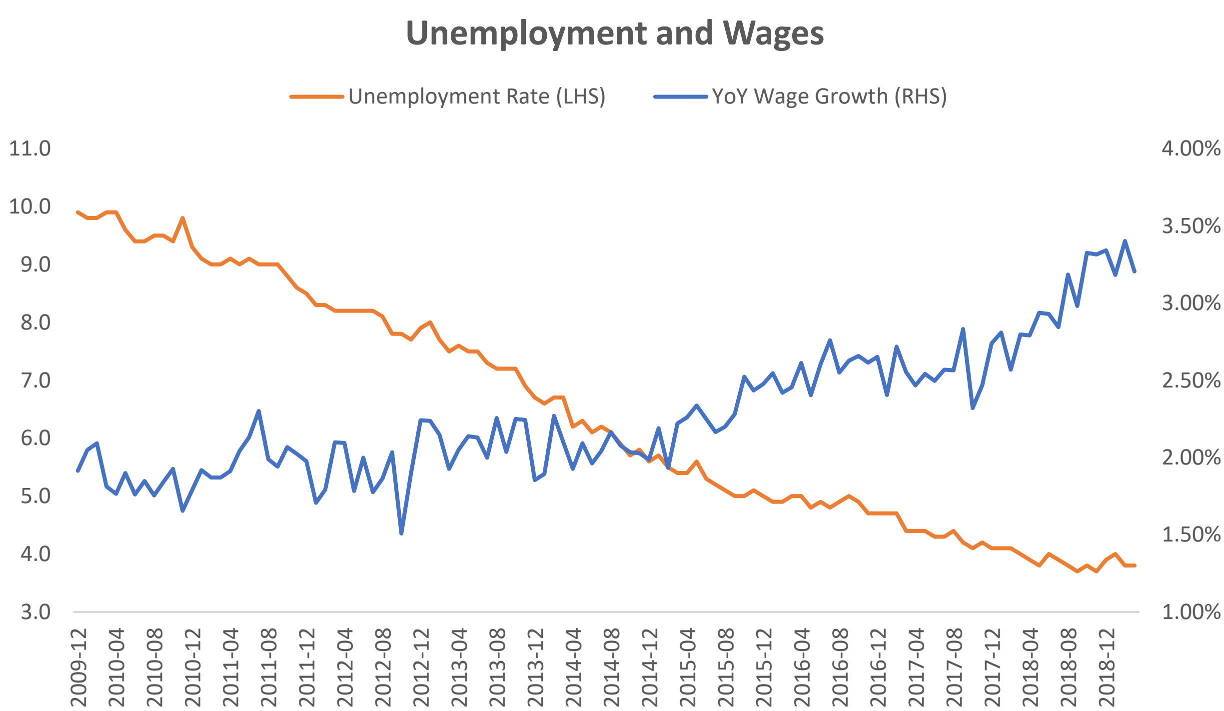


Source: Federal Reserve Bank of St. Louis



Source: Federal Reserve Bank of St. Louis

Source: National Association of Home Builders



Source: Federal Reserve Bank of St. Louis

Disclaimer and Contact Information

Past returns are no guarantee of future results. Results are net of a hypothetical 1% annual management fee (charged quarterly) and 20% annual performance fee. Individual account returns may vary based on the timing of investments and individual fee structure.

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