August 3, 2019

July 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 modest gains across the portfolio. Notable winners during the month included Fiserv, Sherwin-Williams and Moody's. Partially offsetting this were losses from Ryanair and A.O. Smith. During July were net buyers of equities and marginal sellers of bonds. Our top equity positions at the end of the month are AutoZone, Inc. (AZO), Ryanair Holdings plc (RYAAY), NVR, Inc. (NVR), Colliers International Group Inc. (CIGI) and HEICO Corporation (HEI-A). Our five largest positions account for approximately 26.3% of our portfolio exposure.

Rational Optimism

We live in a world of negative interest rates with over twelve trillion dollars of bonds trading at negative yields. This is a world of unprecedented economic pessimism. This pessimism is expressed not only through extremely low interest rates, but also through a cultural dimension. The world is full of people who believe that technological progress has brought no improvement in the standard of living, or that the world is steadily deteriorating. Markets are full of investors who believe that an economic collapse is imminent; full of people willing to pay the German government 0.3% of their principal per year just to hold "safe" 10-Year Bonds.

Since 1928, US stocks have delivered an annualized return of 9.49% while bonds returned only 4.83%. In other words, stocks have outperformed bonds by 4.66% annually. This outperformance is truly astonishing when you consider investing with a long-term horizon. A dollar invested in stocks in 1928 grew to $3,829, while the same dollar invested in bonds is worth only $73 today – a difference in wealth of 52-fold. The S&P 500 currently trades at a forward

Negative-yielding debt hits new record

Bloomberg Barclays Global Aggregate Negative Yielding Debt index, market value ($tn)

Source: Bloomberg
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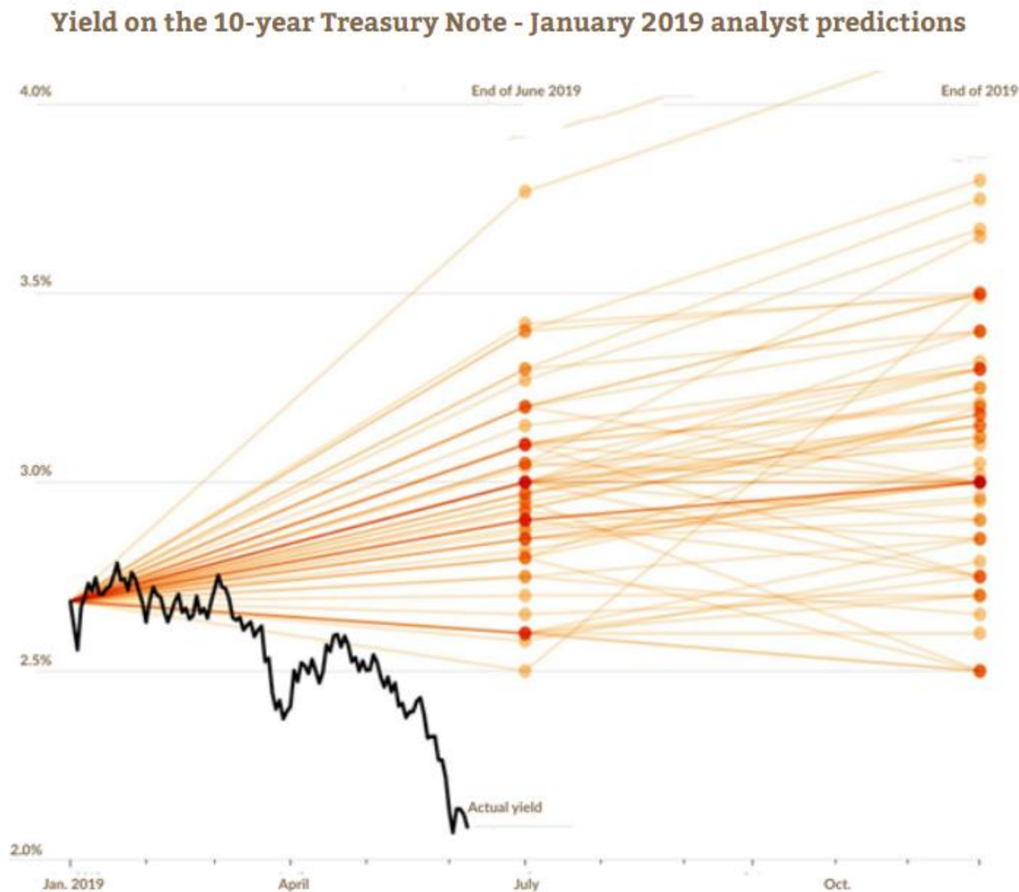
earnings multiple of 17.7x or an earnings "yield" of 5.65%, compared to a mere 2.1% for the 10-Year US Treasury Bond. Furthermore, the S&P500 earnings represent a claim on real assets and will grow over time, while the bond yield is fixed. Real (inflation adjusted) S&P 500 earnings have grown by 2.09% per year since 1928, suggesting that if history is any guide, stocks could deliver investors a real return of 7.74%. Given that US inflation is currently 1.8% as measured by the CPI, stocks appear poised to deliver 9.54% per year for investors – not dramatically different than the historical record of 9.49%. US 10-year bonds on the other hand are priced to deliver just 2.1% year or 0.3% in real terms. This means that the spread that stocks offer over bonds is currently about 7.44% - well above the historical spread of 4.66%. Put in another way: investors must expect corporate earnings to decline sharply or interest rates to more than double, or some combination of those things – soon. Otherwise, stocks appear drastically undervalued relative to bonds. This simple analysis shows just how pessimistic investors have become.

Stocks have performed fantastically for investors over the past ten years with the S&P 500 generating a compounded annualized return of 15.31% over the period including reinvested dividends – well above their long-term average. Stocks represent a claim on real businesses and those businesses have expanded and innovated for decades despite wars, recessions and fears of nuclear annihilation. These innovations have translated not only into gains for stockholders but also the entire human race. The American business person is a hero to whom the entire World should be grateful. There has been no greater century of human progress than the last one hundred years and there has been no greater time to be alive than today. The vast majority of people alive today are better fed, better sheltered, better entertained, better protected against diseases and much more likely to live into old age than their ancestors have ever been. Over the past century, the availability of almost everything has gone up: years in a life, drinks of clean water, breaths of clean air, hours of privacy, means of traveling, ways of communicating, calories, watts, lumens, gigabytes, megahertz, miles per gallon, bushels per acre and of course: dollars per person. We have more vaccines, vitamins, shoes, soap operas, apple slicers, tennis rackets and anything else you can imagine than ever before. By one estimate, the number of products available for purchase in New York City exceeds one billion.

It is essential that people, especially young people, see themselves as participants in one of the most exciting eras in history - to have a sense of purpose. And yet, there are still people today who imagine that life was better in the past. This peculiar rose-tinted nostalgia tends to most afflict the wealthy, many of whom imagine the past to have been a simpler and kinder time. A time of simplicity, tranquility and spirituality. This nostalgia conveniently omits the prevalence of disease such as smallpox, bronchitis and pneumonia. It omits the torturous pains of untreated tooth aches and children dying from drinking unpasteurized milk. The truth is that it is much easier to wax poetically about a peasant life when one does not need to use an outhouse. There has been no better time than the present.

The world is getting steadily better, and it has done so for a long time. In fact, already in 1958, the US economist J.K. Galbraith wrote his famous book, "The Affluent Society" in which he argued that many unnecessary goods were being "overprovided" to consumers by persuasive advertisers. In 1957, the British prime minister, Harold Macmillan proclaimed that the average British working man "never had it so good". Today, the conditions of most households in 1958 would be described as abject poverty – with no access to air conditioning or high-speed internet. There is no way of knowing how much better life will become, and there is no sense in guessing when progress will stop. The gains in life expectancy, to take just one example, show no signs of slowing down. Similarly, there is no point trying to predict a market top or the end of a business cycle. Just because the last ten years have been nothing short of phenomenal for investors does not mean that disaster is just around the corner.

Will interest rates rise sharply and spoil the party? Maybe. But the record of Wall Street analysts of predicting interest rates is astonishingly bad. Below is a chart of the 10-Year US Bond Yield analyst predictions in January of this year vs. what actually happened. If this chart is not the best possible warning against trying to make short term market forecasts, we don't know what is.



Today, an investor purchasing a 10-Year US Bond will earn approximately 23% over the next decade – hardly enough to compensate them for inflation. An investor in US equities on the other hand, can expect to at least double their money over that time period – a far better outcome. We see few reasons for the US economy to tip into recession in the near future. We expect corporate earnings to continue to grow and stock prices to slowly but steadily march upward. As a result, we remain fully invested in stocks and believe that the current level of investor pessimism presents an opportunity for discerning long-term investors.

As we have mentioned in previous letters: we continue to see opportunities in US housing and European low-cost aviation. We will be revealing our third investment "theme" for 2020 in the next few months.

As always, I look forward to answering your questions.

Lukasz Tomicki
Portfolio Manager
LRT Capital

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.

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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