November 1, 2019

October 2019 - Performance Update

Dear Friends & Partners:

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

October was another positive month for our investment strategy, but a mixed bag when it comes to individual names – some of our positions gained strongly, while others declined substantially. Notable winners during the month included UnitedHealth Group Incorporated (UNH), Ryanair (RYAAY), and O'Reilly Automotive Inc. (ORLY). Offsetting these were losses from Progressive Corp. (PGR), Accenture plc (ACN), Colliers International Group Inc. (CIGI), and our Treasury position (TLT). Our top equity positions at the end of the month are Ryanair Holdings plc (RYAAY), AutoZone, Inc. (AZO), NVR, Inc. (NVR), UnitedHealth Group Incorporated (UNH) and Colliers International Group Inc. (CIGI). Our five largest equity positions account for approximately 27% of our portfolio exposure.

We believe that while short-term performance is important, having a **repeatable, sustainable, and consistently executed** investment process is paramount to long-term success – like the process we employ at LRT. With that in mind, we want to say a few words about our Treasury position (TLT) as it accounts for close to 30% of our exposure, has declined for two months in a row, and is what some market commentators are calling "an obvious short." Why do we hold so much money in US Treasuries? Aren't interest rates going to rise and cause us to lose money on Treasuries? We hold Treasury bonds as a form of hedge against market declines and short-term dislocations – when equities fall Treasuries tend to rise (a negative correlation recognized for the last 40+ years). By holding a Treasury position, we have been able to drastically cut our portfolio volatility because of their negative correlation to equities. While aiding our portfolio in times of market stress, Treasuries can also detract from portfolio performance when interest rates rise – this is inevitable, and we must accept periods like this month because we cannot predict the short-term direction of interest rates and we believe no one truly can. See our July Letter for further evidence of how difficult predicting interest rates is. [1]

We sometimes get the question from potential investors – *"I am managing my equity & bond exposure at the portfolio level, why would I want to diversify within an equity investment?"* At LRT, our portfolio position sizing and the percentage of allocation to Treasuries is a function of our rigorous risk management process – it is not a discretionary decision we make on a whim. The allocation to Treasuries is what allows us to apply leverage and outperform in the 'good' times, without the increased downside deviation. There are many times when one may have a "gut feeling" about the short-term direction of interest rates or the stock market as a whole, and it would be tempting to override our risk management process to "improve"

[1] https://www.lrtcapital.com/wp-content/uploads/2019/10/2019-07-July-Performance-Update-Public.pdf

short-term performance. It is the disciplined execution of an investment process that drives performance at LRT, not hunches or gut feelings: we cannot predict short-term market movements, nor do we know anyone who can, and any attempt to override our risk protocols would be detrimental to long-term portfolio performance. You can rest assured that we continue to diligently execute our investment process with respect to position sizing and portfolio allocation, irrespective of the temptation to make short-term market timing calls.

Recent Developments

For many years, LRT Capital was a one-man shop, with yours truly wearing many hats. I am happy to announce that as of November 1st, Benjamin Turk has joined the LRT Capital team and will head up our investor relations and business development efforts. Ben joins me from Insight Equity, a Dallas-based private equity fund where he was responsible for evaluating and executing investment opportunities throughout various industry sectors. Prior to his work in private equity, Mr. Turk was an Investment Banking Analyst in the Natural Resources Group of Deutsche Bank. Mr. Turk also competed in the National Football League, signing with the New York Jets in 2018. Mr. Turk graduated from the University of Notre Dame with a BBA in Finance, where he was the varsity punter and four-year letter winner. To learn more about our company and our investment strategies, you can reach Ben at bdt@lrtcapital.com.

In early October I visited NYC for the Context Summits NYC event, a long running alternative investment conference connecting investors with allocators. Context Summits NYC was a well-organized, two day, "speed dating" event on October 3-4 that I was please to attend. The conference featured an awards ceremony where nominees were vetted by the conference organizers and voted on by the conference participants. I am deeply honored to have won the **"2019 Best Emerging Manager"** award.[2] My sincere thanks go out to everyone who has voted for me, everyone who has supported me over the years, and most of all, to all my investors who have entrusted me with managing some of their hard-earned savings.

At the Context Summits NYC Awards Ceremony, October 2019

[2] https://www.prnewswire.com/news-releases/context-summits-announces-winners-of-annual-365-awards-300932929.html

Ben and I will be traveling to Context Summits in Miami, FL, which will be held at the Fontainebleau hotel between January 29th and 31st, 2020. Context Miami is the flagship conference for Context Summits, and we look forward to seeing many of you in sunny South Florida early next year (please feel free to reach out to Ben if you would like to set up a meeting while we are in town).

Building an investment management business is not easy. Many, many people have helped in this long journey. With the spirit of gratitude in mind, I constantly seek to give back and "pay it forward." One of the things I have been doing a lot of in the past two years is speaking to students and sharing my investing and career insights. During October I had a chance to speak to students at Texas A&M, and later this month I will be participating in the annual University of Texas MBA Investment Fund Advisory Committee Meeting. My thanks go out to Alex Ruth for organizing the event at Texas A&M and inviting me. Thank you for hosting me and showing me around College Station, TX. Our legacy cannot be only about money.

After speaking with students at Texas A&M University, October 2019

The Art of the Deal

We try to stay away from politics at LRT and would not comment on the US political situation under normal circumstances. Having said that, we have fielded a lot of questions over the past few months about the impact of political risk on our portfolio, the potential for an Elizabeth Warren Presidency, etc. Today we want to address the issue of political risk and share the LRT perspective on the US Presidential election in 2020 and how it might impact your investments. We believe the key question for investors is whether or not President Donald Trump will be re-elected in 2020. If the President were to be re-elected, current economic policies in the US are likely to remain stable, while if the Presidency is occupied by a member of the Democratic party, the chances of major policy change are high.

It is easy to become emotional when it comes to President Trump, but it is important to focus on the cold, hard facts. How likely is the President to be re-elected? Let us look at the base rates. Prior to President Trump, there have been nineteen (19) US Presidents since 1900. Seventeen sought re-elections (Harding and Kennedy died in office). Of those, twelve won re-election. In other words, since 1900, incumbent US Presidents have won over 70% of the time. Of the seventeen re-election campaigns, five featured an economic recession during the electoral campaign (Taft, Hoover, Ford, Carter, H.W. Bush). Of these five re-elections, incumbents lost in each and every instance. This information is summarized in the following table.

	Instances	Win	Win %
Incumbent seeking reelection	17	12	70.59%
Incumbent seeking reelection, no recession	12	12	100%
Incumbent seeking reelection, during recession	5	0	0%

This analysis highlights two facts: 1) Incumbents have a huge advantage in being re-elected. It is easy to see why: they have the office of the Presidency, they have a fundraising and campaign team from the previous election, and they have a record of achievements to run on. 2) Re-election success is determined by the state of the economy. Therefore, paradoxically, the personality of the specific candidate running against the incumbent doesn't really matter. If you are predicting that President Trump will not be re-elected, you are de facto predicting a recession next year. Therefore, since making a call on the US Presidential election is really a call about the economy, we must ask: how likely is a recession in 2020?

Predicting recessions is a hard business. Based on all of the information we have right now, the chances of a recession in 2020 look low to us – but predicting a recession more than 6 to 9 months out is indeed very hard. The Federal Reserve cutting interest rates and the potential for a trade deal with China make the odds of a recession even lower. Our base case scenario is that we are going through a manufacturing slowdown like the one we experienced in 2015-2016. A slowdown, but ultimately not a recession. If that is the case, we expect President Trump to run a re-election campaign focused on the strong economy and we expect him to be re-elected in 2020. This would mean a continuation of the status quo with minimal legislative changes coming out of Washington, DC.

If on the other hand, the US economy weakens next year, a trade deal with China is not forthcoming, and unemployment rises, we believe a Democratic victory is almost certain. More importantly, we believe it doesn't really matter who the Democratic candidate is – we could therefore easily have a President Elizabeth Warren if she wins the nomination. Furthermore, in an incumbent election, the party winning the White House is highly correlated with the same party taking control of Congress. If the Democratic Party controls both the Presidency and Congress after the 2020 General Election, we believe the potential for MAJOR policy change goes up sharply in the United States.

At LRT we are prepared for both eventualities, and while we believe President Trump is likely to be re-elected, the mere possibility of a Democratic President is likely to drive significant stock market volatility. We expect this volatility to be a source of opportunity and are planning to take advantage of it in the months ahead.

Elizabeth Warren and Bernie Sanders love talking about taxing the "billionaire class," promising more regulations and free education. But if elected there is one policy area upon which they are likely to have the most impact. According to almost every political poll, the most important issue for voters is…

… Healthcare[3]

Healthcare in the United States is complicated, highly emotional, and increasingly unaffordable for most Americans. The number one issue with healthcare in the United States is the cost. The lack of price transparency makes people feel they are being taken advantage of by their providers and health insurers in their times of need – leading to frustration and anger. Insurers are angry at providers, patients are angry at

[3] https://www.realclearpolitics.com/real_clear_opinion_research/new_poll_shows_health_care_is_voters_top_concern.html

insurers, and politicians promise fairy tales to everyone. The simple reality is that no one truly understands the complexity of the US Healthcare system nor has any real solutions to truly reduce costs. While it is easy to take shots at pharmaceutical companies for highly priced drugs, legislative action remains elusive. Everyone involved supports lowering healthcare costs as long as it does not affect anyone's care and doesn't lower anyone's revenue.

According to the Center for Medicare and Medicaid Services (CMS), roughly one third of all spending in the US goes to Hospital Care, followed closely with Physicians and Clinical Services at 20%.[4] Prescription drugs, which attract so much attention, account for only 10% of all spending. It is therefore clear that to truly tackle the high healthcare costs in the United States, it is the cost of hospital care and physicians that must be addressed. The problem with doing this is building a political coalition that will confront hospitals and physicians. In many counties in the US, especially rural ones, hospitals are the largest single employer. In fact, in sixteen (16) states, hospitals are THE LARGEST single employer in the entire state.[5] How many politicians will take actions that could harm the largest employers in their districts? Call us cynical, but we see almost no chances for anything more than cosmetic changes and fiddling around the edges of the current reimbursement systems for hospitals and physicians – even with a Democratic Congress and President. Having worked in political consulting for several years and having seen how the "political sausage" is made in the US, I feel qualified to make this judgement.

What can be done then? What change is possible given the political realities? We believe that the US Healthcare system is going to evolve towards a SINGLE PAYER system. In fact, the US Government is ALREADY the largest single payer in the healthcare space with combined Medicaid and Medicare spending accounting for over 37% of total spending, ahead of private insurance at 34% (CMS data). The term "socialized medicine" may be a political nonstarter in the United States, but the reality is that the path of least resistance for US Healthcare reform is the shoveling of ever larger amounts of money at the problem and an increasing role of the US Government as a payer but not a provider of care in the US. This growth will take many forms: expansion of Medicaid, more seniors joining Medicare, and various subsidy / premium support programs for private insurance.

The categorization of spending into Medicare, Medicaid, and private insurance is useful in determining the ultimate source of funds, but it obscures the role played by private insurance companies in the system. Within "government healthcare" (Medicare / Medicaid), the fastest growing segments are Medicare Advantage and various forms of Managed Medicaid – which are administered by private insurance companies. Medicare Advantage accounts for approximately 34% of Medicare (CMS data) and is growing faster than overall Medicare. It is really a misnomer to call most of these businesses "insurance companies," because the majority of what they do is help manage healthcare spending without providing any risk-bearing function. Even within the "private insurance" segment, most companies today self-insure with the "insurance company" only providing plan administration and expense management. Instead of calling them insurance companies, using the term health-management organization (HMO) better captures their economic function.

We believe that a single payer healthcare system is where the US healthcare system is evolving. At the same time, we believe there will be an enormous role for private companies within this single payer system, akin to the Swiss or German systems, rather than a government-paid and government-run system akin to the British NHS. As the government takes on a larger and larger role in paying for healthcare costs, the management of spending will take on an ever-larger role to prevent a ballooning of the costs. The US government does not currently have the competencies to manage healthcare spending in the same way as

[4] https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/highlights.pdf
[5] https://www.beckershospitalreview.com/rankings-and-ratings/hospitals-largest-employers-in-16-states.html

HMOs. Given ten years of time and a dedicated political effort, could such competencies be developed? Possibly, but given the low level of trust in government and short-term outlook of the US political system we believe it is more likely that this function will continue to be played by the HMOs. This separation of responsibilities between a payer and health plan manager, will also be convenient for politicians who will simultaneously want to control costs (to keep taxes low) and redirect blame for costs controls and the denial of care onto the HMOs. Call it a mutually beneficial circle of hypocrisy: where everyone blames everyone else while actively hoping nothing ever changes.

Finally, there is the question of costs, political retribution, and the "greed" of health insurance companies. The proof the effectiveness of the HMO model is the growing share of Medicare enrollees who choose Medicare Advantage[6] and the costs savings of Managed Care overall. Whatever the rhetoric, the profit margins of the largest HMOs do not suggest excessive market power. The net margin of HMOs ranges from 3.6% (Cigna) to 5.55% (UnitedHealth Group), and the corresponding returns on equity range between 12.61% and 25.62%. Reasonable, but hardly outlandish. For comparison, the average net margin of a company in the S&P 500 was 9.45% in Q2 2019.[7] Put in yet another way, the total net profit of the four largest HMOs accounted for just 0.67% of total US healthcare spending. Given the vital role that these companies play in the management of US healthcare spending, we believe this is a bargain price.

As the economy evolves over the next twelve months and presidential political pundits try to out shout each other, we believe the stock prices of many healthcare companies will be driven by the fears and uncertainties stemming from a potential Democratic takeover of the US Presidency and the US Congress. It is our baseline assumption that the outcome of the presidential election will be largely determined by the US economic outlook in 2020, with a strong economy favoring the incumbent President, Donald Trump and the Republican party. Should this prediction prove erroneous and a Democratic candidate win the race to the White House in 2020, we believe their ability to change the US healthcare system will be limited in comparison to the optimistic campaign rhetoric delivered at political rallies. Specifically, we believe that US HMOs represent a vital part of the US healthcare system and will fare reasonably well regardless of the political outcome. We have acted on our convictions.

Careful readers of our letters will have noticed a new position amongst our "top 5" investments mentioned in our September letter.[8] This new investment is UnitedHealth Group (UNH), and it entered our portfolio on October 1st, replacing Danaher, Inc. (DHR). As we have already mentioned, stock price returns in the healthcare sector over the next twelve months are likely to be driven by non-economic issues, such as the uncertainty surrounding the US Presidential election. Why invest now, you may ask? Simple: valuation. We profess no ability to time short-term market moves or predict the madness of crowds, but we can see a bargain when it is staring us right in the face. UNH possesses a strong competitive advantage, is going to grow over time, has a management team that has done a good job at capital allocation, AND is available for purchase at an attractive valuation – we believe it would be foolish to forgo investing simply because of uncertainty about the short-term returns.

To see just how cheap the stock is, simply turn to the next page. The chart on the following page is a composite of two metrics: UNH's stock price and its trailing price-to-earnings (PE) ratio (in blue). As you can see, the stock price has gone nowhere during the past two years while the company's valuation got steadily cheaper and cheaper. What is more, the "true earnings" of the company are understated by approximately 10% because the company is amortizing a large number of intangible assets created during acquisitions executed over the past five years – something that wasn't the case in the past and that obscures comparability to historical valuation multiples. The red vertical line reflects our purchase point. So far, the

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[6] https://www.kff.org/medicare/issue-brief/the-facts-on-medicare-spending-and-financing/

[7] Source: Capital IQ.

[8] https://www.lrtcapital.com/wp-content/uploads/2019/10/2019-09-September-Performance-Update-Public.pdf

stock is up over 15% since our purchase due to a better than expected earnings report. We expect more of such "surprises" in the months ahead.

We purchased shares in UnitedHealth Group (UNH) when they were trading at the lowest valuation on an earnings basis, in more than five years – a reflection of the relatively gloomy outlook for the company's future. We believe this gloom is unwarranted. Our purchase of UnitedHealth Group is a perfect opportunity to demonstrate our investment process with a concrete example. Frequent readers of our letters will know that we are always looking for three characteristics in any company we buy: a sustainable competitive advantage (moat), the ability to grow and reinvest, and a management team with a demonstrated history of good capital allocation. Here is how UnitedHealth Group (UNH) matches up on these criteria:

Moat – UNH has a deep moat around its business. It benefits from intangible assets in the form of regulatory barriers to entry and economies of scale by spreading fixed costs over a large number of insured patients. Government regulations of the healthcare industry are like a form of chemo-therapy: only the largest and strongest cells (companies) can survive – this is evident from the way the industry has consolidated over the years. Most importantly, UNH it is the market leader in Medicare Advantage with nearly 25% market share. Together these advantages translate into best-in-class margins and returns on invested capital.

Growth – The company's growth is a function of the growth in the number of insured patients, the growth in spending per patient, and change in business mix. Medicare enrollment is growing by over 10,000 people per day and within that, Medicare Advantage (where United has the #1 market share) is growing as a share of Medicare.[9] UNH is benefiting from an aging US population and a change in its business mix as the United States continues to embrace managed care as an alternative to the fee-for-service model. The potential for an even larger role of the US government in healthcare spending in the event of a Democratic President in 2020 should only add to this growth.

Capital Allocation – UnitedHealth Group uses capital in two ways: to forward integrate into health delivery (48% of revenue is now tied to this part of the business – OptumHealth, OptumRx and OptumInsight) while the remaining cash is returned to shareholders through dividend and

[9] https://www.lek.com/sites/default/files/insights/pdf-attachments/2135-Medicare-Advantage-Penetration.pdf

buybacks. We think the capital allocation strategy has been balanced and opportunistic, although we would like to see more buybacks given the current price of the stock.

We expect UNH to grow its topline by 8-10% annually over the next decade, with operating margin expansion and capital returns adding another 5-7% to annualized returns in the foreseeable future. Overall, we expect intrinsic value to grow at an approximately 15% / year clip over the next decade while we expect the stock price to deliver slightly greater returns as the uncertainty related to the US Presidential election dissipates and the valuation expands. Coupled with the recession-proof and predictable nature of UNH's business, we see this as an excellent risk/reward given the lateness of the macro-economic cycle in which we find ourselves.

Investors often ask us how we are positioning the portfolio for a recession. While we do not believe we can predict when a recession will hit, we are modestly tilting the portfolio more towards less cyclical and slower growing companies. One of the ways to do this is by adjusting the growth profile of the companies we are seeking. We are clearly many years into the US economic expansion, and easy gains in GDP, employment, and company toplines are hard to find. We believe a recession, or at least a significant economic slowdown, is drawing nearer every day – although we can never be certain of the timing. In an environment of significantly slower growth we are more inclined to pursue investments in companies with slower but steady growth and the much lower valuation that accompanies it. There are other times when we would be inclined to pursue very fast-growing companies at much higher valuations – as we believe a macro-economic environment of fast growth would be more likely to allow such companies to deliver on their embedded expectations.

Over the next twelve months we expect increased volatility in the health care sector due to the prospect of regulatory changes tied to electoral promises made by politicians trying to get elected. We believe this increased volatility will present several opportunities for investment in high-quality companies at attractive valuations. We hope to find one or two companies in the healthcare sector that will eventually make it into our portfolio during 2020. We are actively doing due diligence on several prospective investments in the sector and want to be ready to act with high conviction when the opportunity presents itself. **Stay tuned.**

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

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