January 2, 2020

December 2019 - Performance Update

Dear Friends & Partners:

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

December was another positive month for our investment strategy with broad gains across the portfolio. Notable winners during the month included Colliers International Group Inc. (CIGI), Canadian Pacific Railway Limited (CP), UnitedHealth Group Incorporated (UNH), and Ryanair Holdings plc (RYAAY). Offsetting these were losses from HEICO Corporation (HEI-A) and our US 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.

The Stealthy Bear Stalking the Dow[1]

The title of this section refers to an appallingly silly Wall Street Journal article by James Mackintosh published on October 22nd, 2019. It appeared in the WSJ only a week before the major market indexes surged to new all-time highs. Mackintosh's article is a perfect representation of the tone and content of most financial journalism this year: dire predictions and speculations about the apocalypse, even as equity markets marched upwards. It is a perfect example of how "news" coverage of the stock market is diametrically opposed to what is actually happening.

In 2019, the S&P 500 total return index delivered a 31.49% return[2], "Trump's tariff wars" did not tip the economy into recession, and the dreaded "earnings recession" failed to materialize. The key driver of the US economy remains the strong job market, which continues to go from strength to strength – delivering numbers not seen in generations, if ever. Job creation in the last months of the year has actually accelerated – 10 years into the longest economic expansion in US history – something that professional economists said was impossible. Even more impressively, the labor force itself continues to expand with millions entering the job market since the beginning of the year. Hourly wages are up over 3% year-over-year, payrolls are up, and joblessness for minority groups is at a historical low. In short, more people are working, and for higher pay, than ever before in US history.

All the data suggests that we are living in the most dynamic, innovative, and entrepreneurial of all the world's economies – the United States. Nonetheless, we can always count on financial journalists to hype

[1] https://www.wsj.com/articles/the-stealthy-bear-stalking-the-dow-11571742003

[2] Source: Capital IQ

whatever "crisis" comes to hand, causing large numbers of investors to make the Big Mistake. The Big Mistake is staying out of the market, not investing due to short term fears. If you are an individual or an organization with financial goals longer than three years – the only sensible way of funding them is through investing in equities. Fear mongering by the financial press is succeeding – as the data on fund flows showed record withdrawals from equity funds/ETFs and inflows into bonds during the year[3] – reaching levels not seen since the Crash of 2008. This fear and pessimism are not new.

Here is an excerpt from an email exchange I had with a potential investor in 2016:

> *"I am more prone to investing in CTAs […] I just don't think that long term and starting from today's valuations the stock market is going to deliver good returns."* – ***May 5th, 2016***

Note the date on the excerpt above. How does this investor feel today? Since May of 2016, an investor in the S&P 500 would have earned a return of over 68%, while an investment in the LRT Economic Moat Strategy would have returned substantially more.

We don't pretend to know what the stock market will do over the next thirty days but remain committed to the disciplined execution of our investment strategy over the long-term. In the LRT Economic Moat Strategy, we continue to invest in a portfolio of remarkable businesses: possessing strong competitive advantages, reinvesting capital at high rates of return, and led by intelligent capital allocators. These companies will thrive and grow more valuable over time – and we as shareholders will benefit.

In the words of Warren Buffett: *"Time is the friend of the wonderful business and the enemy of the mediocre."* Over the period of the next several years, we expect our investment strategy to significantly outperform cash, commodities, and the S&P 500 index. Equities remain undervalued in the United States and around the world, especially in relationship to the debt markets. We believe that major market indexes will continue their upward march in the years and months ahead – with the occasional wobble and "panic" along the way. History is on the side of the optimists. **Optimism is the only realism.**

The Bubble Basket – An Update

While we remain optimistic about equities as an asset class, the same cannot be said for all companies. The price one pays for a stock has a huge influence on subsequent returns. In our February Letter[4] to you, we introduced a "Bubble Basket" – a list of software-as-a-service (SaaS) businesses that while outstanding companies, were priced, in our opinion, at levels that would make it impossible for investors to earn a good return. Most of the companies in our basket were loss making, so we valued them using a price-to-sales (P/S) ratio, with the median company in the basket trading at an astonishingly high P/S of 10.23 at the time of our writing. To understand how absurd such a valuation is, consider the words of the former CEO of Sun Microsystems, Scott McNealy:

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at

[3] https://www.wsj.com/articles/investors-bail-on-stock-market-rally-fleeing-funds-at-record-pace-11575801002
[4] https://www.lrtcapital.com/wp-content/uploads/2019/10/2019-02-February-Performance-Update-Public.pdf

$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"[5]

We warned that such a high valuation was unlikely to end well for investors and that it was reminiscent of the dotcom bubble. Specifically, in our letter to you, we said, *"Because the starting valuations are so high, even if everything goes according to plan, returns to shareholders are likely to be mediocre at best over the next three years."*

So, what happened since? Since the start of our live experiment, The Bubble Basket[6], equally weighted, returned 5.13% while the S&P 500 delivered a total return of 17.68%. We will update you on the progress of our Bubble Basket in a couple of months, but we hope this little example helps demonstrate that no company's stock is worth paying an infinitely high price – no matter how good the business. Returns are strongly influenced by the prices paid – the lower the price you pay the better the odds of your success. Valuation matters, not only in the short term, but it can impact investment returns for years.

Positioning, Valuation and Low Expectations

Best Buy (BBY) and Amazon (AMZN) are two giant retailers in the US. Over the past seven years, Best Buy's revenue and net income stayed flat, while earnings-per-share (EPS) rose by 3.47% per year (due to buybacks) – a poor performance to say the least. By comparison Amazon's revenue, net income, and EPS grew by 25%, 48.6%, and 46.8% per year annualized – one of the most successful business records in the history of the world. Best Buy closed stores and shrank its footprint while Amazon entered and dominated new and exciting areas of business, such as cloud computing and video streaming. Given these statistics you might be surprised that Best Buy delivered a better return to shareholders over the past seven years than Amazon. Shocked? Yet, the annualized rate of return over the past seven years has been 33.03% for Amazon and 36.65% for Best Buy.[7] How can this be?

Simple: Best Buy started out with an extremely low valuation and extremely low expectations, while the expectations for Amazon were very high. In 2012, Best Buy traded at an extremely low EV/EBITDA ratio of 3x and a PE of 5.9x, while Amazon commanded a valuation of 37.5x EV/EBITDA and a PE of 126x. Hence, despite the strong business performance, Amazon's stock price has underperformed its rival Best Buy which started out with very low expectations. Valuation, expectations, and investor positioning clearly matter to future returns.

After a remarkable year, like the one that just ended, there are fewer areas of the market where expectations are low. Most stock prices reflect optimistic expectations about the future – a recipe for poor near-term returns. As a result, we don't expect broad market indexes to repeat their 2019 performance. On the other hand, we expect the LRT Economic Moat Strategy to outperform the broad equity markets in the year ahead because of our **clearly defined and repeatable process** – the same process that has driven our long-term outperformance. We have a clear investment process and will not deviate from our proven long-term strategy in order to engage in unreliable short-term investment tactics like market timing or "tactical hedging." Now is not the time to take money off the table, lock in gains, or look for shelter. We have a strategy that is clearly working – now is the time to press our advantage and build on the phenomenal results from the past year. We are always first and foremost focused on the disciplined and consistent execution of our strategy – not predicting short-term market movements.

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[5] Businessweek, 2002

[6] 2/28/2019 through the end of the year

[7] Source: Sentieo

At LRT we remain laser-focused on finding pockets of opportunities in the market, where for temporary reasons, investors are ascribing low expectations to otherwise extraordinary companies. It is with this focus on long-term business value and a clear-eyed understanding of the impact of investor positioning and expectations that we approach the year ahead. We accept the difficult challenge of building on our results from 2019. It is a humbling task, even further so given our market outperformance in 2017-2018.

I want to thank you all for your trust and continued support in the New Year, and as always, please don't hesitate to reach out with any questions you might have.

Lukasz Tomicki
Portfolio Manager
LRT Capital

Appendix I: Investment Philosophy

In the past twenty-four 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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