THE VISION TO SEE
UNREALIZED VALUE

February 3, 2020

January 2020 - Performance Update

Dear Friends & Partners:

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

We launched our second strategy in January – the LRT Market Neutral Strategy. Like the LRT Economic Moat Strategy, the Market Neutral Strategy invests in a portfolio of competitively advantaged companies but seeks to hedge the long-market exposure via short positions in various large-, mid-, and small-cap indexes. Overall, the strategy will have a net long exposure between 20-30%, but market neutral on a beta-adjusted basis. The first month of the Market Neutral Strategy performance was burdened with ~100bps of one-time startup costs – we expect better performance in the months ahead. If you are interested in learning more about the LRT Market Neutral Strategy, please contact Ben Turk at bdt@lrtcapital.com.

For our Economic Moat Strategy, January was a marginally negative month. Notable winners during the month included Progressive Corp. (PGR), Moody's Corporation (MCO), and US Treasury position (iShares 20+ Year Treasury Bond (TLT)). Offsetting these were losses from AutoZone, Inc. (AZO), AO Smith Corp. (AOS) and O'Reilly Automotive Inc. (ORLY). 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.

Our Mandate

The core challenge for investors is finding ways to preserve capital while increasing spending power in the face of the ongoing rise in living costs (inflation). Cash can't do this for you. Bonds can't do this for you. The only asset class that has historically outperformed inflation by a significant margin is equities. If you have an investment objective that is three or more years in the future – only equities can help you fund it. Long-term investing in high-quality companies remains the surest path to long-term prosperity. Simple index investing is a sensible strategy for the novice investor trying to capture the long-term upward thrust of the equity markets. However, studies have shown that the majority of wealth creation comes from a tiny handful of companies.[1,2] Therefore, at LRT, we focus our attention on identifying and owning these few exceptional businesses and believe that taking a more discerning approach that focuses on company fundamentals can yield **higher returns with lower volatility** than a passive index. As I am sure you have heard (*if you are reading this letter*), we focus on companies with three characteristics: a sustainable competitive advantage, the ability to grow and reinvest capital at high incremental rates of return, and management teams with a proven ability to intelligently allocate shareholder capital. Through disciplined and repeated execution of our investment process we have been able to generate consistent alpha. Our strong historical results demonstrate the efficacy of our approach.

A Dash for Trash

A bullish fever has engulfed equity markets in January with investor optimism driving all asset prices to new highs. Ray Dalio, the head of Bridgewater Associates, declared that "cash is trash" during an interview in Davos earlier in the month.[3] The CIO of Bridgewater, Bob Prince, added to this sentiment by saying that "the Boom-Bust cycle is over,"[4] a comment that eerily reminds us of Ben Bernanke's "Great Moderation" speech from 2004,[5] and Gordon Brown's "no more boom and bust".[6] We believe these comments will not age well, but they are a perfect reflection of where we are in today's economy: equity markets are buoyant, the US economy is proving resilient to macroeconomic shocks, and the Federal Reserve is supportive of investors' interests by providing ample liquidity to the market. The Federal Reserve's three interest rate cuts in 2019 and its short-term repo operations that began in October of last year aimed at providing additional liquidity to the money markets have succeeded in restoring investor confidence and pushing up asset prices. In fact, we believe investors are becoming too optimistic and asset prices are being priced to perfection, making them vulnerable to sharp declines should liquidity or sentiment falter.

In fact, **<u>the best returns in January accrued to the companies with the worst possible fundamentals</u>**. Hence the title of this section. Here are just a few examples:

- Beyond Meat (Nasdaq: BYND) – a small and profit-less maker of "fake meat" jumped +46.06% during the month. The company now trades at 15.6x P/S, and 215x EV/EBITDA. No earnings. LTM cash from operations: -$32 million. Market cap: $7.2 billion.
- Smile Direct Club (Nasdaq: SDC) – a recently IPO-ed maker of direct to consumer teeth straightening products jumped +53.19% during the month. The company now trades at 4.6x P/S, and 254x EV/EBITDA. No earnings. LTM cash from operations: -$336 million. Market cap: $5.1 billion.
- Tesla (Nasdaq: TSLA) – the profit-less electric car maker jumped +55.52%. The company now trades at 3.5x P/S, and 35x EV/EBITDA. It has a market cap that exceeds $100 billion. No earnings. LTM cash from operations: $3.2 billion. Market cap: $103 billion.

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[1] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2900447
[2] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3415739
[3] https://www.cnbc.com/2020/01/21/ray-dalio-at-davos-cash-is-trash-as-everybody-wants-in-on-the-2020-market.html
[4] https://www.bloomberg.com/news/articles/2020-01-22/bridgewater-co-cio-bob-prince-says-boom-bust-cycle-is-over
[5] https://www.federalreserve.gov/boarddocs/speeches/2004/20040220/
[6] https://www.telegraph.co.uk/finance/recession/3497533/Gordon-Brown-admits-he-was-wrong-to-claim-he-had-ended-boom-and-bust.html

- Uber (Nasdaq: UBER) – the loss-making rideshare business rose +22.03%. The company now trades at 4.9x P/S, and a $64 billion-dollar valuation. No earnings. LTM cash from operations: -$3.1 billion. Market cap: $64 billion.

It is clear to us that many investors have thrown caution out of the window and embraced the riskiest possible investments in a search for returns. Such hubris generally comes before the fall. During the month of January this was a winning strategy – in the long-run it is folly and investors who chase such stocks will be badly hurt in the months ahead.

In our last investor letter, we showcased the impact that valuations can have on stock returns.[7] Simply put, if you pay too high of an initial price, you may fare poorly as an investor even if the underlying business performs perfectly. Valuations may not matter in the short term, as sentiment and liquidity can overwhelm fundamentals, but the price you pay has a huge impact on long-term investment returns. People chasing money-losing momentum stocks will come to rue the day when the tide finally turns. To paraphrase the famous value investor, Leon Trosky: "You may not be interested in valuations, but valuations are interested in you."

We want to stress that at LRT we have stayed far away from this madness. Nor do we make any attempt to time the market, put on "tactical hedges," or short individual companies – and neither should you. All the companies we own trade at reasonable, albeit not bargain, valuations today. We invest only in companies with durable competitive advantages, high levels of profitability, and very stable business models. Our portfolio companies will never deliver the kind of returns that the speculative issues described above can in a 30-day period, but rather, will compound in value for investors over long periods of time. In the event of a market downturn we expect the businesses we have invested in to be more resilient than the market overall and provide us with additional opportunities to increase our investment at attractive prices. With respect to investing, the tortoise really beats the hare.

Crossdressing for Beginners – When Stocks Become Bonds

A curious thing has begun to happen over the past few years – investors have been buying stocks for their dividend income while buying bonds for the potential capital gains.[8] Historically, it was conservative, often retired, investors who picked bonds for their steady income streams, and it was aggressive investors who picked stocks. Today it seems the world has flipped on its head, with investors who seek income investing in equities for their dividends, as the interest offered by bonds has dwindled to nearly nothing. Bonds, on the other hand, have become trading instruments purchased for their capital appreciation potential – the opposite of what used to be normal.

Asset prices are extremely sensitive to interest rates when interest rates are very low. As a result, bonds have become trading assets, held for very short periods of time by traders trying to capture short-term price movements. At the heart of the matter is the ever-increasing universe of negative-yielding bonds. As investors are certain to realize losses from holding such instruments to maturity, the only hope they have for any gains is to capture short-term profits from capital appreciation. This amplifies volatility in the bond market and can have unpredictable consequences in the future. What's more, while volatility in fixed income has increased, the total returns offered by the asset class continue to diminish. Since short-term trading is a zero-sum game, someone's gains must be someone else's losses.

[7] https://www.lrtcapital.com/wp-content/uploads/2020/01/2019-12-December-Performance-Update-Public.pdf
[8] https://www.ft.com/content/6cdd55a6-eff2-11e9-ad1e-4367d8281195

On the flipside, formerly conservative investors seeking a steady income have become much larger holders of equities than ever before as the vast majority of global stocks offer higher income than global bonds. Whether this is a "systemic" risk is debatable…but what is certain to us is that many investors have been lulled into a false sense of safety by the long bull market that began in 2009. Conservative, retired investors seeking a safe income stream will face a rude awakening when the economy turns south and stocks exhibit high levels of volatility. Such volatility will come as a shock to many investors as it has been absent during the past decade. How investors who purchased stocks for their "safe and steady" dividends react to such volatility remains to be seen.

The Bubble Economy

Low interest rates and huge dosses of liquidity continue to underpin the global economy. It is not our job to complain about this, but rather to navigate this environment to the benefit of our clients. The huge amounts of liquidity available are giving rise to bubbles and overvaluation across many asset classes. Commercial real estate cap rates are at historical lows, and home prices across major metropolitan areas around the world have reached records levels, fueling a rise in inequality and resentment between the "have" landlords and "have-not" renters. The environment of extremely loose money has given rise to many unorthodox business models where companies are burning money in the hope of establishing scale.[9] The abundance of cheap capital has made this possible.

Uber, Snapchat, Lyft, Moviepass, WeWork, BlueApron, Wag, Purple – these are just a few of the many companies burning investors' money in the pursuit of "scale." All of these companies are hiring people, renting offices, purchasing supplies, and buying Google Ads. The impact of their aggregate spending on the economy is real, albeit hard to measure. How much of Google's growth in the past decade has come from such money-burning businesses buttressed by a wall of cheap investor cash chasing the hope of high returns?

In the mid-2000s, the mortgage market meltdown affected the economy through several channels: banks that held mortgage-backed securities had their balance sheets impaired, homeowners saw the value of their properties decline and reduced spending (the wealth effect), home equity withdrawals slowed to a trickle, and home construction activity collapsed. Together these factors contributed to the worst recession in a generation. *How are things different today?* For one, risk appears to have shifted to venture investors chasing "unicorns," and private credit has replaced subprime loans, while mainstream banks have dramatically reduced risky lending since the crisis. It therefore appears that the financial system is better prepared for an economic slowdown (should one occur).

On the other hand, the aggregate spending in the economy fueled by low interest rates is hard to estimate, but if the bubble economy in which we live ever bursts, many companies will find themselves in dire straits, and in turn their suppliers will be hurt. Only time will tell the magnitude of the impact this will have on the economy.

In the near-term future the outlook for inflation, and therefore the actions of the Federal Reserve, remains paramount. As the economy gallops ahead and unemployment levels continue to explore new lows, we expect the focus to shift towards interest rate hikes by the Fed. This increased scrutiny of the future path of interest rates will likely mark an end to the stratospheric rally that we have been experiencing over the past few months and lead to a period of sideways trading or even outright decline in the US stock market.

[9] https://www.nytimes.com/2018/05/16/technology/moviepass-economy-startups.html

At LRT we remain extremely cautious about the overall market and more judicious than ever about the valuations we are willing to pay for companies. While many companies appear reasonably valued today, such valuations are only "*reasonable*" based on an extrapolation of today's ultra-low interest rate environment and continued, uninterrupted economic growth. We believe the market's focus will soon shift towards the prospect of higher interest rates, leading to increased stock market volatility. We believe this volatility will be a source of opportunity for discerning investors who focus on company fundamentals and are not taken by the investing fad of the day. While we remain cautious, we continue to find attractively priced, high-quality companies, in mundane businesses – all at valuations that can deliver attractive returns to long-term holders. We are confident that our portfolio will compound capital at rates of return in excess of the overall market in the months and years ahead.

Thank you for your trust and ongoing support. 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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