LRT CAPITAL MANAGEMENT

THE VISION TO SEE
UNREALIZED VALUE

March 2, 2020

February 2020 - Performance Update

Dear Friends & Partners:

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

February was a challenging month for broad market indexes such as the S&P500, the Nasdaq, and the Russell 2000. Markets all around the world fell sharply due to rising fears triggered by the spread of the coronavirus (COVID-19). Both of our investment strategies lost money during the month of February but outperformed the broad indexes. Over the long term we expect the LRT Economic Moat Strategy to deliver between 150%-200% of the upside of the S&P500 with about 70%-80% of the downside. We are never happy when we lose money, but it is important to highlight that, during the month, the LRT Economic Moat Strategy delivered 55% of the S&P500's downside – in line with our expectations, while the long-term outperformance of our strategy on the upside is evident in our track record. Our strong relative performance is a result of our unique portfolio construction process, our use of US Treasuries, and our disciplined risk management. We expect the S&P500 to rebound sharply in the months ahead and we believe we will participate in that upside in a disproportionate way – in line with our historical results.

During the month, all our equity positions in the LRT Economic Moat Strategy had a negative impact on performance which was partially offset by strong positive returns from our US Treasury holdings (TLT). Our top equity positions in the LRT Economic Moat Strategy at the end of the month are, in order: AutoZone, Inc. (AZO), Ryanair Holdings plc (RYAAY), NVR, Inc. (NVR), Colliers International Group Inc. (CIGI), and UnitedHealth Group Incorporated (UNH). Our five largest equity positions account for approximately 26% of our portfolio exposure.

LRT Market Neutral Strategy was marginally lower for the month but confirmed its lack of correlation to the broader markets. The strategy is working as we expect it to, and we believe returns will improve materially in the months ahead.

At LRT, we will continue to act in a disciplined way to deliver predictable returns from our repeatable investment process. Our investment strategies are a result of many years of work that has led to a refinement of our investment process and the development of proprietary risk management tools. The software we have created helps us manage risk and determine optimal portfolio position size. Over the past two years we have built a great foundation to continue to grow – both in terms of our technology and our team. We do not rest on our laurels and continue to invest in our investment research process and our organization.

Assets under management now exceed $47 million, and we will update you periodically on the growth in this important metric. We are also pleased to announce that Leo Ouyang has joined our team as an investment research analyst. Prior to joining LRT, Mr. Ouyang worked at Century Management as an Equity Analyst in Austin, Texas. He was directly involved in the fundamental analysis of new investment opportunities, as well as the maintenance of necessary research and updates on existing securities. Leo holds an MS in Financial Economics from Texas A&M University and a BS in Materials from East China University of Science & Technology. He is currently a CFA level 3 candidate.

We have heard from many of you about the coronavirus and want to address the issue directly. We are not epidemiologists at LRT nor medical professionals, but we can address the financial impact of the virus on markets. This is not the first time a viral threat has occurred. There have been many outbreaks of disease in the past. In the past two decades there has been an ample amount of fear and market volatility induced by similar outbreaks. Specifically:

- SARS in 2003-04, also originating in China
- The bird flu epidemic in 2005-2006
- In 2009, a new strain of swine flu
- The Ebola outbreak in the autumn of 2014
- The mosquito borne Zika virus outbreak in 2016-17

The most severe of these, in terms of market impact, was the SARS epidemic. Without belaboring the point: the first victim of SARS – a fishmonger – checked into a hospital in Guangzhou on January 31, 2003, basically infecting the whole staff. The epidemic exploded from there. On that first day of the litany of epidemics cited above, the S&P500 closed at 855.70. Seventeen years and six epidemics later (including the current one), this past Friday the Index closed at 2954.22, more than 3.5x higher. We are confident you can see where we are going with this. The end is not nigh. This too shall pass.

Investors are always confronted with reasons to be scared – the trick is to invest anyway. Financial markets rise over time as companies grow their earnings. If you are thinking about selling because you believe markets are "a little high" and might fall from here, you will be absolutely shocked how much higher they will be in 20 years' time. Markets and societies are resilient – people adapt to even the direst of circumstances. The coronavirus has made the immediate future more uncertain, but if you sell now, and then wait for an "all clear" signal to buy in again, you will be buying at much higher prices. In investing one pays a very high price for the feeling of "certainty."

Broad market indexes are down over 10% in the past two weeks, with many companies exposed directly to travel down more than 25%. This is an opportunity. We at LRT believe that this selloff presents a chance to increase our investment in many wonderful businesses whose stocks are currently "on sale" due to short-term fear. We are bullish on America and the equity markets overall. You should be as well.

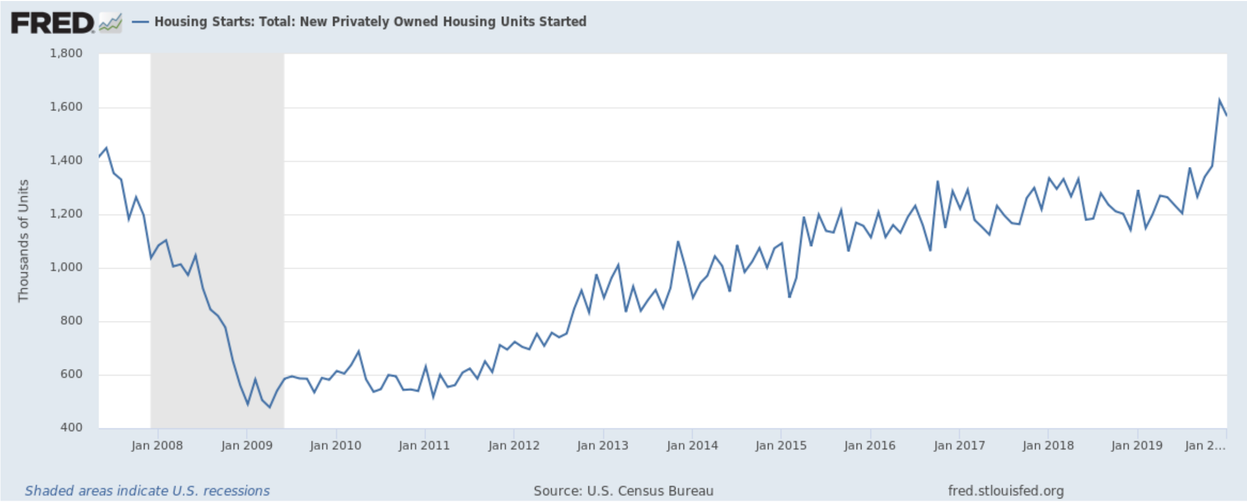
The Best of Years

With the news reporting a rise in coronavirus infections every day it is easy to focus on the negatives. We believe it is extremely important to see the bigger picture: the world is getting steadily better. The reality is that 2019 was the best year in the history of humanity – yet again.[1] The number of people dying from

[1] https://www.spectator.co.uk/article/we-ve-just-had-the-best-decade-in-human-history-seriously-29-december-2019

diseases, war, or ethnic violence is at all-time lows.[2] Literacy, access to electricity, and the empowerment of women are all up. Don't let the pessimists get you down. Not only has 2019 been the best year in human history, the 2010s have been the best decade. See and read the articles in the footnotes of this page – they are not investment advice, but they are good for your soul.

More pertinently to investing, US housing continues to strengthen and hit new cycle highs.[3] We have highlighted US housing starts several times in the past year.[4,5] Specifically, in September 2019, we said *"We believe US Housing has lots of room to grow. Expect more good news on this front."* – the chart below tells the story of what has happened since. At the risk of being repetitive, we reiterate what is going on: more people are working in the United States and for higher pay than ever before in history. Mortgage rates are at historical lows. Housing construction over the past decade has not kept up with population growth. This is a recipe for continued strength in housing and we expect housing to be a source of strength for the US economy in the months ahead. You can rest assured that our portfolio is positioned to benefit from this trend.



This is not to say that markets go up in a straight line or don't experience volatility – the last week of February 2020 is proof! Historically markets have a correction – a euphemism for losing lots of money quickly – every year. Statistically, a decline of 10% or more happens every year. In 2018 there were two, in 2019 none, so the long-term average still holds. **<u>You must have the fortitude and mental strength to ignore short term noise and persevere through occasional dips.</u>** Investing opportunities are often the greatest when the headlines are the bleakest. To that end we wrote in our December 2018 letter to you: *"Risks are currently to the upside […] – long term investors should be buying equities. Our Partnership is doing just that. […] Now is the time to invest."*[6] If you had the courage to invest in our Economic Moat strategy then, you were rewarded with **net returns** of more than double the S&P500 in 2019.

None of this is to say that our forecasting track record is perfect. Decency requires – and our compliance insists – that we tell you about the times when we were wrong. For example, we have in our letters to you over the past two years, on occasion, warned that a US Economic slowdown or recession is likely because of the flat or inverted interest rate term structure – and yet it failed to materialize. However, we do not believe that perfect foresight is possible or even necessary to attain investment success – and we think that

[2] https://www.nytimes.com/2019/12/28/opinion/sunday/2019-best-year-poverty.html
[3] https://fred.stlouisfed.org/graph/?graph_id=513153
[4] https://www.lrtcapital.com/wp-content/uploads/2019/11/2019-09-September-Performance-Update-Public.pdf
[5] https://www.lrtcapital.com/wp-content/uploads/2019/11/2019-05-May-Performance-Update-Public.pdf
[6] https://www.lrtcapital.com/wp-content/uploads/2019/10/2018-12-December-Performance-Update-Public.pdf

our results are proof of that. We publish all our investor letters on our website. They are available for you to review at your leisure.[7] You can see exactly what we said, where we were right, and where we were wrong. We believe that in today's day and age investment management requires absolute trust and absolute transparency. The publishing of our letters online is our attempt at building that kind of relationship with you.

It's Not What You Know – It's How You Act

If you are a frequent reader of our letters, you may be familiar with our three-pronged stock selection criteria. For those that aren't, here is a quick refresher. We invest exclusively in companies with three characteristics:

1. A sustainable, competitive advantage, i.e., "Moat"
2. The ability to grow and reinvest capital.
3. Management team with a demonstrated track record of intelligent capital allocation

These three principals may sound familiar to you. Chuck Akre talks about a "three-legged stool," Pat Dorsey searches for similar themes, and even Terry Smith's investment approach sounds familiar. What then makes the LRT strategy unique? Why has the LRT Economic Moat Strategy outperformed the S&P500, hedge fund indexes, and most other value managers? **Even more importantly, how likely is this outperformance to continue?**

The key to great investment success is largely in how you act over time, not how much you know. Over a short period of time a man with a great insight or two can outperform, but over a longer period it is the man with a consistent and well executed strategy that will win. By this we mean executing your investment strategy in a disciplined and repeatable manner, and improving it were possible based on evidence. It means avoiding falling into emotional pangs of greed and despair. It means establishing risk management rules that shield you from losing money but allow you to compound your capital over long periods of time. We are all imperfect and susceptible to human biases – prisoners of our own biology – and we must build rules and systems to escape our fallibilities. Warren Buffett put it best when he said that beyond a certain point it is not intelligence that determines investment success but temperament.

At LRT, our asset selection is qualitative and discretionary, but our portfolio construction method is a systematic and quantitative process that determines portfolio position sizing. We do this monthly and mechanically execute trades to achieve the portfolio risk profile dictated by our process. Furthermore, in the LRT Economic Moat Strategy, we hold US Treasuries, which we access through the TLT ETF. In practice, our portfolio today holds about 30% of our dollar exposure in US Treasuries (historically 20-35%), over-weights lower volatility and low market correlation securities, and seeks to minimize internal position correlation. If you look at our top five equity holdings, you will see that they are a very diverse bunch with no obvious common theme – this is proof of the risk management process working.

Investing is largely a loser's game – just like tennis. For most of us, who aren't tennis pros, winning in tennis comes down to returning the ball consistently – avoiding so called unforced errors – and letting the opponent lose. Sooner or later, the overly aggressive or undisciplined player will hit the ball into the net or

[7] https://www.lrtcapital.com/investor-letters/

out of the court and you will score. A similar dynamic applies to investing – avoid big errors, avoid emotional biases, stay in the game, and let your winners run.

Our risk management process and unique portfolio construction is what truly distinguishes the LRT Economic Moat Strategy from that of most value investors. Every strategy occasionally loses money – the only question is how one handles the losses. Having a systematic process is crucial to our success because our losses are managed, their portfolio magnitude understood, and their size controlled and acceptable.

Here are a few concrete examples: If a company's business model is unpredictable and the company does not have a strong competitive position, guess what? It's not going to be in the LRT portfolio. If it is in the portfolio, and the price declines, and we still believe in it, we will most likely buy more, but only to the extent that it is necessary to bring it back to the targeted risk exposure. If a company's stock is very volatile it is going to be a small part of the portfolio. If a company is not volatile historically, but becomes more volatile over time, it will shrink as a percentage of the portfolio. If a position that is large as a percentage of the portfolio becomes more correlated with other portfolio holdings it will be cut in size. If all stocks become more volatile, the percentage of the portfolio allocated to stocks will decline and our bond position will rise. Finally, if a company's competitive position deteriorates, its growth prospects decline, management does something out of character with respect to capital allocation (for example: a "transformative acquisition" when acquisitions were eschewed in the past), or the stock becomes overvalued while more attractively valued alternatives exist, we will exit the position.

We hope this gives you a clear sense of how we manage risk in our portfolio to both protect the downside but also **grow your money**. Our portfolio construction and risk management process is systematic, repeatable, and consistently executed over time – that's why our outperformance over the long-run has been consistent.

Final Thoughts

It is important to remain calm in periods of market turmoil. Playing sports, being in nature, or simply going for a walk can help you see things differently. As Winston Churchill once said: "If you are going through hell; keep going." Or as we like to do, whenever we are going through a tough period in the markets or in life, recall the words written over a century ago by Austrian poet Rainer Maria Rilke:

> "Let everything happen to you
> Beauty and terror
> Just keep going
> No feeling is final"
> **— Rainer Maria Rilke**

As a friend of mine said: when the going gets tough, the tough get going. Join us as we seek opportunity as others seek shelter. 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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