April 3, 2020

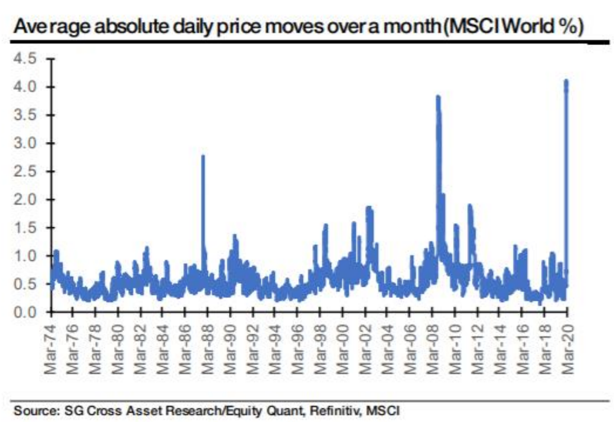
March 2020 - Performance Update

Dear Friends & Partners:

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

March was a brutal month for our portfolio and all broad market indexes. Our results during the month are a result of unprecedented market and economic conditions. We have taken strong actions to protect the portfolio from further declines and expect to generate strong returns in the months ahead that will offset these temporary loses.

The 'Coronapocalypse'



Source: SG Cross Asset Research/Equity Quant, Refinitiv, MSCI

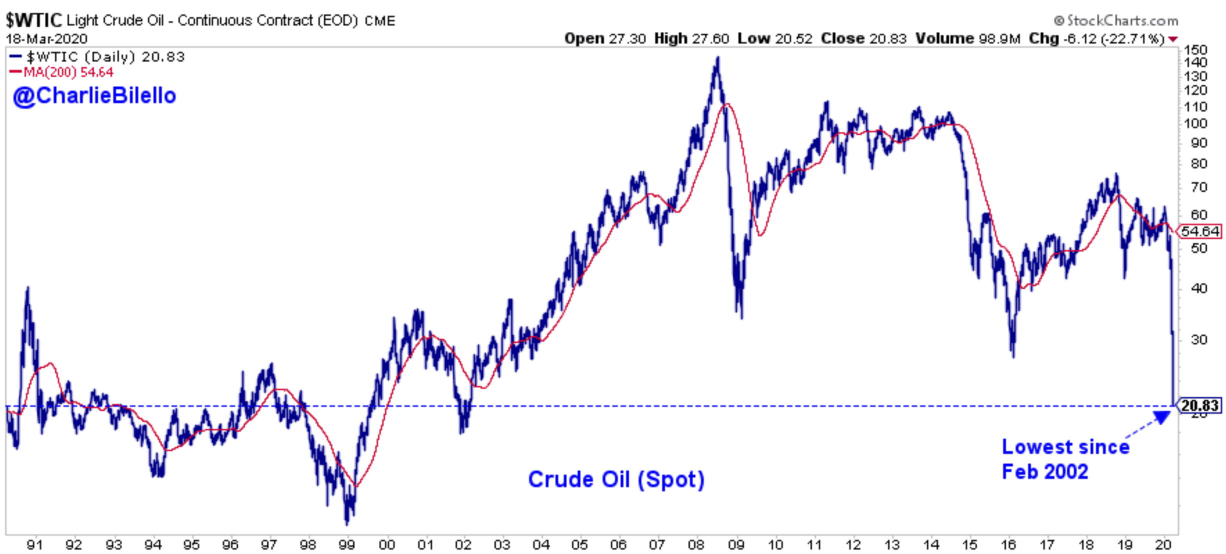
During the month of March, markets have experienced a true "black swan" event with the spread of the covid-19 ("CV19") pandemic – resulting in a catastrophic collapse of economic activity and world markets. The speed and severity of this decline has rivaled and, in some cases, exceeded that seen during the 2008-2009 Global Financial Crisis (GFC)[1,2,3,4]. While initial CV19 news emerged in mid-January causing a small market sell-off, the decline quickly reversed as aggressive containment measures in China brought the epidemic to a halt. There have been multiple outbreaks in the past including SARS, MERS, Ebola, and the N1H1 flu, which proved to ultimately have a limited impact, and CV19 appeared to be following a similar trajectory. However, starting in late February, the news of the virus' rapid spread to countries outside of Asia triggered more sharp declines in markets, accelerating further as

[1] https://www.ft.com/content/8605e046-696b-11ea-800d-da70cff6e4d3
[2] https://www.ft.com/content/90876f5c-6cf0-11ea-89df-41bea055720b
[3] https://www.ft.com/content/6addc002-6666-11ea-800d-da70cff6e4d3
[4] https://www.wsj.com/articles/credit-hedge-fund-suspends-redemptions-in-sign-of-market-stress-11585660093

the severity of the situation in Italy became clear, including stories of overwhelmed medical facilities, which exacerbated the death toll.

These news were followed by increasingly aggressive containment measures being announced across the world: cancellations of large events, work-from-home measures, travel restrictions, forced 14-day quarantines for international visitors, full regional lockdowns, the cancellation of sporting events such as the NBA and the Olympics, and finally a complete closing of all public areas. The closure of retail venues and restaurants accelerated the negative implications for the broad economy. Celebrities and politicians began to become infected during the month – heightening the fear of powerlessness in the face of an invisible enemy. Almost every day during March gave us news that went from bad to worse, in turn giving rise to fears that this public health crisis could morph into a global depression and an all-out financial crisis.

The OPEC+ group also delivered a punch to the global economy when it announced that it would not cut production and instead increase supply significantly to regain market share. This caused oil prices to collapse by over 50% during the month, which will have significant consequences for the oil producing sector, the unsecured debt holders, their bank lenders, and the currencies of many countries. Many oil rich countries that have previously accumulated financial assets during a period of high oil prices will now be forced to draw down on their sovereign wealth funds to support government spending on social programs, further exacerbating the selling pressure in financial markets. In other words, the world has experienced not one but two sharp shocks in rapid succession – an extremely rare occurrence.

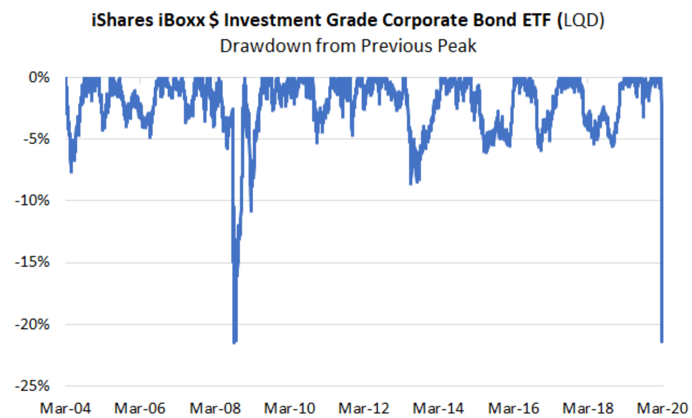


The market reaction has been unprecedented, off the charts and eye popping – *we are running out of adjectives here*. The list of extreme occurrences during March is long. The fastest fall into a bear market ever[5]. The highest closing price in the VIX at 82.69 ("the fear index"), topping the highest readings from the GFC[6]. Three of the six worst days in the history of the Dow Jones Index occurred in March[7]. The put-

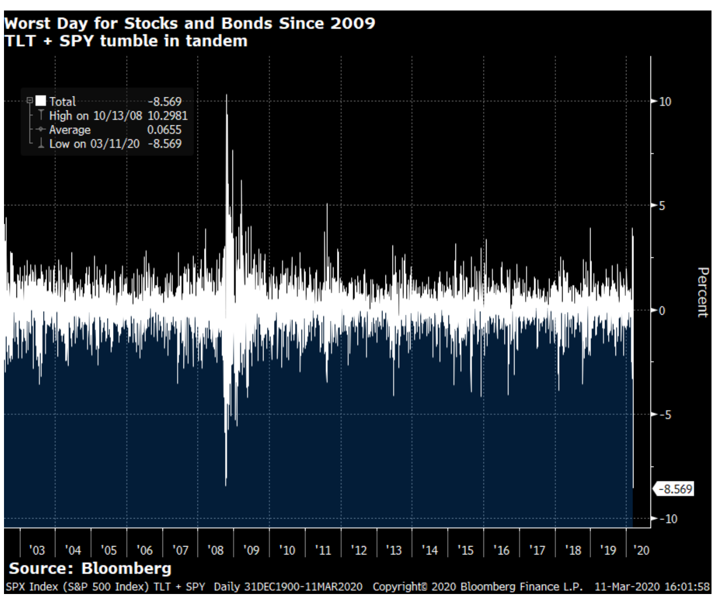
[5] https://www.bloomberg.com/news/articles/2020-03-12/hunting-for-the-bottom-of-the-fastest-u-s-bear-market-ever
[6] https://www.cnbc.com/2020/03/16/wall-streets-fear-gauge-hits-highest-level-ever.html
[7] https://www.vox.com/2020/3/16/21182341/dow-jones-biggest-point-drop-coronavirus-3000

call ratio reached never-before seen highs. Spreads on corporate debt exploded to levels not seen since the GFC.

More anecdotally: the serviced office space that we use in downtown Austin has been fully occupied for several months – we asked for extra space a month ago and were 5th on the waiting list with no vacancies expected. By late March, we have been offered a choice of four different offices. This is a small service office space and we estimate their vacancy has risen from zero to 30%+ in a matter of weeks as businesses have folded and reneged on lease agreements. In addition, several mid-level executives at public companies that we know personally, have told us they are planning to fire 10-15% of their work forces over the next few weeks as they implement plans to conserve cash amid an unprecedented collapse in demand.

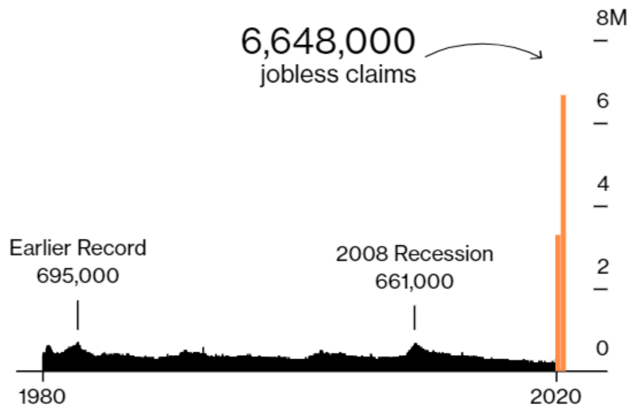


Making matters worse, the historic correlations between asset prices broke down during the month – hurting many well-known hedge fund strategies[8]. Historically, bonds and stocks move opposite to each other – a fact of life we rely on for risk management in our strategy. This correlation broke down in mid-March, further hurting our results. What's more, even the correlation between stocks and volatility products such as TVIX broke down by late March. Historically investors could hedge their equity portfolios by being long TVIX which moved opposite to broad equity markets. By March 23rd this ceased to be the case and financial markets began experiencing a period where TVIX and the SPY moved **together**. Essentially all portfolio construction and risk management techniques failed or became less effective during the month. This largely explains our monthly losses.



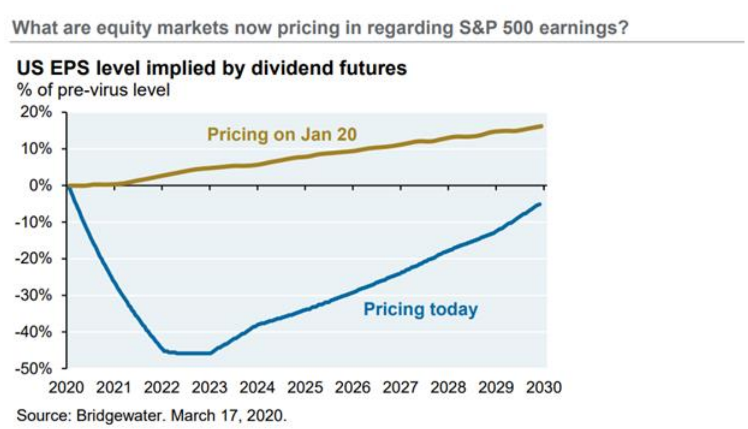
[8] https://www.ft.com/content/182a7edc-6a0c-11ea-a3c9-1fe6fedcca75

The Real Economy



The impact on the real economy is only beginning to be felt. Unemployment claims have exploded – far surpassing the records seen during the GFC recession. We believe that the small rally in the stock market we have seen over the last few days of March is fake and driven largely by end of month portfolio rebalancing effects. Investors are still in denial about the severity of this economic shock. Stock prices follow earnings, and earnings are likely to hit very hard over the coming weeks and months. Unemployment could well exceed 30%[9]. While the response from the Federal Reserve and the Federal Government has been swift, it is hard to see what else can be done. The Federal Reserve has cut interest rates and started unlimited quantitative easing. The Federal government has passed a two trillion-dollar stimulus bill. There is little more that can be done. Before the stimulus bill, the Federal deficit was expected to be around $1 trillion dollars, add to that the decline in tax receipts due to the recession and the newly passed stimulus, and the deficit could reach $4 trillion dollars or 20% of GDP. Can the Federal government keep printing money and bailing everyone out? We believe that the policy response has been swift but is largely priced in at this time, while the hit to corporate profits is still largely ahead of us. That is why, we expect we will see lower stock prices in the months and weeks ahead.

Actions Taken



What is an investor to do in this environment? Stay calm and behave rationally. During March many of the correlations between asset prices that we have historically relied upon for risk management began to shift. By mid-March our we experienced three days of unprecedented losses which we could not explain with historical data or simulations. During that third day, we decided to dramatically reduce our market exposure from about 200% gross leverage to under 50%. In other words, about 50% of our portfolio today is invested with the rest in cash.

The current public health crisis is turning into a global economic crisis that will bring opportunities to discerning investors with cash ready to be deployed. We plan to remain in cash over the next weeks to take advantage of the lower prices we expect in the weeks ahead. What's more, Ben and I are actively working to raise additional capital in anticipation of the great opportunities we see ahead.

9 https://www.cnbc.com/2020/03/30/coronavirus-job-losses-could-total-47-million-unemployment-rate-of-32percent-fed-says.html

While the health crisis is dire, the end if not nigh. We will overcome this, just like the GFC of 2008-2009 was overcome. Stock prices will make new highs and companies will once again report record profits. We thank you for patience and understanding during this difficult time. Finally, I want to extend a special thank you to all of you who have increased your investment with using the past 30 days. We won't let you down.

The "Coronapocalypse" we experienced in March is a rare event, but we do not take it lightly. Being hostage to the global economy and market turmoil has us rethinking our portfolio construction strategy. We plan to make major changes to our portfolio construction approach in order to reduce our correlation to the overall market and make sure that we never find ourselves hostage to market events. We have historically hedged our equity positions through a long position in US Treasuries which we achieved through the TLT ETF. Going forward we will utilize direct hedges through market indexes to dampen portfolio volatility and reduce the impact of idiosyncratic market risk. We will provide further details on these planned changes in the months ahead.

The month of March cost us dearly. We down but not out. The opportunities ahead are going to be spectacular. The impact of the CV19 pandemic is subject to enormous uncertainty, but what is known is that strong businesses are going to survive and thrive after this crisis is over. Our goal is to be positioned to flourish after this period ends. We continue to invest alongside you and we remain focused and committed to our long-term success. We are excited for the future and thank you for your ongoing trust and support.

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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