LRT CAPITAL MANAGEMENT

THE VISION TO SEE
UNREALIZED VALUE

May 4, 2020

April 2020 - Performance Update

Dear Friends & Partners:

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

April was a strong month for both of our investment strategies. The LRT Economic Moat strategy was holding ~50% cash throughout the month and still outperformed the S&P500 during April, which returned +12.7%. We continue to expect weakness and volatility in the overall market in the months ahead and believe we will have the opportunity to deploy our remaining cash over the next few weeks. Returns year-to-date are below our expectations, but we remain optimistic and confident in our repeatable investment process and our ability to generate outsized returns in the months ahead. With respect to the LRT Market Neutral strategy, we continue to make improvements to the strategy at the margins which we expect will bear fruit in very near future. We expect the strength we saw in April to continue in the months ahead.

If we want things to stay as they are, things will have to change[1]

After the drubbing we took in March and the rebound in April, it is sensible to ask: how are we changing our strategies? Fundamentally, we remain qualitative stock pickers, and we continue to focus on identifying and investing in exceptional companies, which we define as those possessing a **strong competitive moat**, the ability to **grow and reinvest capital** at high incremental rates, and lead by management teams with a demonstrated track record of **good capital allocation**. This part of our strategy remains consistent. However, we believe that what has historically separated our investment strategy from those of our competitors is our unique focus on a quantitative and systematic portfolio construction. This part of our investment process deserves a reexamination.

Historically, in the LRT Economic Moat strategy, we determined a list of 20-25 companies we sought to invest in, set portfolio constraints and then used a proprietary optimization process to determine portfolio position weights. The crucial question has always been how much of a constraint to impose on the optimization process. Historically, we have imposed pretty tight constraints, with the majority of our portfolio position weights "binding" at the constraints. During April, we spent a lot of time reviewing this part of the investment strategy. We concluded that this approach has led to a portfolio allocation that was

[1] Tancredi Falconeri from, "The Leopard" by Giuseppe Tomasi di Lampedusa, 1958

quite heavily pro-cyclical – weighted more heavily towards companies that benefit from economic growth. The previous process had been a positive for our portfolio during the past several years but resulted in a deep drawdown that we are now having to dig out of. Eliminating these tight constraints allows the optimization process to be more dynamic and reduces the cyclicality of the overall portfolio. We intend to adjust our optimization constraints – seeking to build a more balanced portfolio with respect to its cyclical exposure.

Secondly, while we are currently holding a substantial amount of cash in the LRT Economic Moat strategy, we expect to deploy this cash over the next few weeks and return to a more "normal" allocation in our strategy. Until recently we have leveraged the portfolio 1.75x. We intend to permanently reduce leverage to 1.6x, going forward.

Third, and final, we will be raising the allocation of US Treasuries in our portfolio, to closer to 35% exposure, up from the previous approximate 30%. This-combined with the leverage reduction described above-will bring our equity exposure down by about 20% with respect to net capital.

So, what does all of this mean for our investors? Expected returns should decline to by about 10% (not 10% in absolute terms, but 10% relative to what they were before), while volatility and drawdowns should be reduced by 30% each. Rest assured, we still expect to outperform the S&P500 in the months and years ahead! These are of course projections based on models and as all models, they should be taken with a grain of salt. However, my message to you is this: after our portfolio rebounds from the current drawdown, **we are thoughtfully adjusting our strategy to substantially reduce volatility going forward while only modestly reducing returns.** We are currently going through a difficult period, both in investing but also in life – with friends and family affected by the COVID-19 pandemic. As dark as it seems now, we are confident that things will get better – both in our investment performance, and in the COVID-19 crisis. America's best days always lie ahead.

This Time Is Different (No Really!)

The annual Berkshire Hathaway meeting was held this past weekend in Omaha, Nebraska. For the first time in its history, the meeting was conducted entirely virtually, with Warren Buffett speaking into a microphone while seated in a completely empty auditorium. For those of us who don't relish getting up at 2am to secure good seating at the CHI Health Center in Omaha, this was a welcome change. At the same time, I personally regret not being able to take in the festive atmosphere and meet with friends and colleagues during our annual pilgrimage to Omaha.

The highlights of the meeting were as follows:

- Warren Buffett sold all of his airline stocks.
- He has made no significant new investments since early March.
- His cash pile grew.
- He sees no real bargains in the stock market.

Buffett's conundrum is the same one we have struggled with since the middle of March: **stocks are pricing in a sharp recovery in the economy while all the data we see suggests a prolonged slump**. The stock market ramp higher continued during April, while the economic outlook continued to worsen. This presents a problem for fundamental value investors as bargains appear to be are scarce. How bad are things looking in the real economy? Let us cite just a few examples from the last week of April:

- 4.4 million filed of jobless benefits, bringing the past six-week total to over 26 million[2]
- Existing home sales fell -8.5%[3]
- New home sales fell -15.4%[4]
- Oil dropped below zero[5]
- Consumer spending dropped 7.5%[6]
- New auto sales dropped 32%[7]
- Retail sales dropped -8.7%[8]
- US airport traffic dropped 96%[9]

Bad enough you might say? But wait, there is more. Negative interest rates – a sign of profound economic weakness – have been around for several years now. In April, they were joined by **negative oil prices**. There is now such a glut of oil, that people must be paid to take oil instead of paying for it. But wait, there is even more! A less publicized, but equally shocking headline, is "negative revenue" – that's right, Delta Airlines said that at the end of March it started experiencing negative daily revenue, because its refunds were exceeding its sales.[10]

The depth of this economic collapse is clearly unprecedented. Historically, a deep economic crisis has led to a deep bear market. Yet, despite all this, the S&P 500 has rallied some 30% since its March bottom and is now down only approximately 11% for the year. What gives? Could this time be different? Is the worse of the stock market decline over or will we be facing a "retest" of the low and potentially much lower prices ahead?

The role of the Federal Reserve must be considered in this crisis. The Fed has acted quickly and decisively, much more so than in past recessions. What's more, past recessions have almost always been brought on by a tightening of financial conditions, usually engineered by the Fed to stop inflation and cool the economy. This is diametrically different in this crisis. Liquidity is everywhere, and seasoned bond issuers, ("well-known companies"), can issue debt without any problems and at record low rates. Simply put, the Fed is working hard to make fixed income investments as unattractive as possible. By buying US Government debt and keeping nominal interest rates much below the expected rate of inflation, the Fed is pushing investors into real assets. As Ray Dalio of Bridgewater Associates eloquently put it, "cash is trash."[11]

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[2] https://www.wsj.com/articles/millions-of-u-s-workers-continue-to-seek-unemployment-help-amid-coronavirus-11587634201
[3] https://www.nar.realtor/blogs/economists-outlook/march-2020-existing-home-sales
[4] https://www.reuters.com/article/usa-economy-housing/u-s-new-home-sales-fall-sharply-in-march-idUSL2N2CA0U9
[5] https://www.wsj.com/articles/q-a-how-oil-markets-work-and-why-prices-fell-below-zero-11587582195
[6] https://www.wsj.com/articles/personal-income-household-spending-coronavirus-march-2020-11588197997
[7] https://www.wsj.com/articles/u-s-auto-sales-plunge-in-april-but-signs-of-hope-are-seen-11588360884
[8] https://www.cnbc.com/2020/04/15/us-retail-sales-march-2020.html
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[10] https://www.fool.com/investing/2020/04/23/delta-air-lines-earnings-coping-with-coronavirus.aspx
[11] https://www.cnbc.com/2020/01/21/ray-dalio-at-davos-cash-is-trash-as-everybody-wants-in-on-the-2020-market.html

Investing is a game of meta-analysis, not analysis. It is therefore not the outcome of economic events that matters to financial markets, but rather the difference between the outcome of events and the expectations of the participants. The fact that many famous investors have continued to call for a retest of the stock market bottom, suggests to us that such an outcome is now consensus. In the words of George Soros, "money is made by discounting the obvious and betting on the unexpected." In past crisis, cash was king, as desperate, overleveraged asset owners sought liquidity. This is the true difference from crisis past: there is no liquidity or financing constraint being imposed on investors or companies at large.

At LRT, we don't have a crystal ball or the ability to foretell the future, but we believe it is prudent to consider a scenario in which the stock market's worse decline really is behind us and new highs lie ahead in the near future, i.e. the risk of missing a rally. We must take seriously the possibility that the Federal Reserve has embarked on "Project Zimbabwe", i.e. it is truly destroying the value of the dollar – an action that will almost certainly lead to massive inflation in financial assets. If there is no liquidity crisis between now and when the economy ultimately recovers, why would stock prices drop? Investors can indeed look past the deep recession that is currently at hand. Afterall, the lower interest rates are, the less important current year earnings are to the valuation of any financial assets.

As we have said in the past, the stock market tends to do what will hurt the most people the most. We currently believe that the path towards the greatest pain for most investors is up. As a result, in our Economic Moat strategy, our portfolio is positioned to benefit from a rebound in the economy while retaining the flexibility to ramp up our investment exposure should further volatility emerge. We expect to deploy the majority of our spare cash over the next few weeks.

The month of March cost us dearly. In April, we have begun the long road back toward profitability. We believe that the current environment has made most investors "armchair epidemiologists" and "macro tourists" – opining about the impact of the Coronavirus on the economy and the stock market. We believe this is an environment in which fundamental stock picking will thrive – and fundamental stock picking is at the heart of our investment process. While the stock market's response to the recession may be different this time, we believe one thing ultimately will not be different. Whether the economic rebound from the current crisis takes the form of a V, U, L, W or any other letter shape – **the recovery will ultimately occur**. People and economies are resilient. They adapt and recover from even the most dire of circumstances. The end is not nigh.

We have added new assets under management and new investment partners over the past 60 days. We thank you for your ongoing trust and the opportunity to help grow your hard-earned savings. We are excited for the future. The best of days are ahead.

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.

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LRT Capital Management, LLC
401 Congress Street, Suite 1540
Austin, TX 78701
Office: +1 512 852 4320
www.lrtcapital.com