August 1, 2020

July 2020 - Performance Update

Dear Friends & Partners:

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

July was a very strong month for both of our investment strategies. We continue to add assets from existing and new investors. Thank you for your trust and patience. We expect the strength we saw in July to continue in the months ahead. While 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 going forward. For details on our performance attribution and holdings, please see Appendix I.

Most Stocks are Losers

The LRT investment process is focused on investing exclusively in companies with three characteristics: 1) a durable competitive advantage, i.e. "a moat", 2) an ability to grow and reinvest capital over time, and 3) a management team with a demonstrated ability to allocate capital effectively. These elements: a moat, growth and capital allocation form the three-legged stool of our investment process. We believe it is periodically useful to go back to basics and explain our investment process in detail. In today's letter we will focus on the first part of our investment process: moats.

Stocks have been a fantastic investment and the best performing asset class over the past hundred years. The United States stock market, as measured by the S&P 500 Index, returned over 9%[1] annually since it was created in 1926 – a period that includes the Great Depression, two World Wars, McCarthyism, the Vietnam War, the Cold War, and two US military interventions in Iraq. Despite the ever-present short-term problems and the ever-negative media which paints an image of a world always going from bad-to-worse, the stock market has been a fantastic place to invest and likely will be in the foreseeable future. However, while the stock market as a whole has been a great place to invest, most stocks have not. The majority of stocks since 1926 have **negative returns** over their lifetime, and almost 60% of stocks don't even outperform T-bills.[2]

[1] Source: Sentieo

[2] "Do stocks outperform Treasury Bills?" - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2900447

Surprised? How can this be? How can stocks as an assets class deliver over 9% per year, while most stocks have negative returns? The reason is that stock market returns are high skewed, that is, the majority of the return is driven by a small group of extraordinary winners. In fact, all wealth creation in the US stocks market is accounted for by only 4% of stocks.[3] Over the long-term, capitalism works to drive down returns and companies without barriers to entry fall victim to competition. Competition, mismanagement and excessive leverage, all conspire to kill most businesses over time. As a result, most companies make for poor investments, and most stocks are losers – that is why most investors without a well-defined investment process will fail to beat market indexes.

At LRT, we believe that investors who want to outperform and pursue an **active investment strategy**, should focus their attention on companies that can keep competition at bay and generate outsized returns over the long-term. That is why we focus exclusively on investing in companies with moats (durable competitive advantages). Absent a moat, excess profits will be competed away. We believe that only companies with a durable competitive advantage, i.e. "a moat" can produce excess returns over the long run – and that is why identifying and understanding the moat is the first and most important part of our investment process.

The term "moat" was first coined by Warren Buffett who taught investors to look for businesses with barriers to entry and competitive advantages.[4] At LRT, we believe, moats are a structural characteristic of a business, separate from its management team. While a management team can create, deepen or destroy a company's moat, management itself if not a moat. It is usually better to be a shareholder in a business with a strong moat and an average management team than one with a great manager but in an industry with a reputation for poor returns. A well-managed airline will never be as profitable as even a mediocre software company. So, what is a moat? Well it depends on who you ask. At LRT, we classify moats into four categories:

Intangible assets (brands, patents, licenses, government approvals)

- **Brands**: Change consumer behavior by delivering a consistent or aspirational experience. Must increase consumer's willingness to pay or lower search costs. Examples: Ferrari, LVMH, Coca Cola
- **Patents**: Legal monopoly. Must be based on a broad portfolio of patents instead of only one or two. Single patent companies are very vulnerable to challenge / expiry / piracy. Examples: Qualcomm, Chr. Hansen, Nvidia
- **Licenses/Approvals**: Legal oligopoly. Subject to regulatory fiat. Key is to analyze the barriers to entry. Examples: Las Vegas Sands, Intercontinental Exchange, Stryker, HEICO, Transdigm

Network effects

Provide a good or services that increase in value as the number of users expands.

[3] "Wealth Creation in the U.S. Public Stock Markets 1926 to 2019" - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3537838
[4] "In business, I look for economic castles protected by unbreachable 'moats.'" – Warren Buffett - https://www.berkshirehathaway.com/letters/1995.html

- Aggregate demand by connecting fragmented groups of buyers and suppliers. Examples: C.H. Robinson Worldwide, Pool Corp, Watsco.
- Benefit from the non-linear relationship between network nodes and network connections. Examples: Visa, Mastercard, Facebook, Tencent.
- Avoid radial networks such as Western Union and favor interactive networks such as Visa and Paypal.

Switching costs

Switching costs arise anytime it is risky, difficult, expensive, or time consuming to switch suppliers. Ask: does the cost and risk of changing suppliers justify the benefits?

- Integrate tightly with customer business processes – upfront costs of implementation and training yield payback from renewals. Examples: Adobe, Jack Henry, Cerner.
- Sell ongoing service relationship vs. one-time purchase. Examples: Rolls Royce, Oracle, Kone.
- Provide a high benefit / cost ratio. As long as you are a small part total costs you can raise prices without much customer pushback. Examples: Fastenal, Ecolab, Symrise.

Durable cost advantage (scale or process based)

Cost advantages must be durable. They are not always tied to size – they dependent on specific industry economics.

- **Process Based:** Invent a better or cheaper way to deliver a good or service that rivals cannot quickly replicate. Examples: Progressive, Inditex, Ryanair.
- **Scale Based:** Spread fixed costs over a relatively large revenue base to reduce per-unit costs or achieve pricing power. Relative size matters more than absolute size. Examples: Amazon, UPS, Walmart.

The analysis of competitive advantage is a complex topic. The above classification is only a start. Today we want to give you a sense of the intricacies involved in the understanding of moats. There are many common misconception out there when talking about moats, competitive advantages and barriers to entry. Here are a few examples:

Most brands are not a moat. Despite being considered a competitive advantage, most brands are not moats, and history is full "great brands" that are now bankrupt: Blockbuster, Circuit City and Toys R Us are just some examples. A brand must lower search costs or increase willingness to pay in order to constitute a moat. Tiffany's jewelry commands a price premium of 15-20% over nearly identical jewelry from Blue Nile. But we are willing to spend 20% more in the hope that the smile on the recipient's face will be 20% larger. On the other hand, how much more are you willing to pay for a Blu-ray player with a LG logo on it vs. a Sony logo? Probably not much.

High market share is not a moat. High market share is often associated with a scale-based cost advantage, but this is a tenuous connection at best. High market share did nothing to prevent Fitbit, Motorola or Dell from being outcompeted.

Low-cost strategies are not a moat. Most low-cost strategies are not built on durable low-cost advantages. A company may have a low cost for a while but only until an even lower cost competitor comes along. If a company's unique business process can be copied it usually will.

Network effects alone are a poor moat. Most network effects are a weak advantage unless there are also high switching costs. What is Uber's network effect worth when switching to using Lyft is so easy? Why did Facebook succeed while Friendster, Orkut and MySpace failed? Facebook integrated more deeply with people's lives, built an ecosystem of apps and APIs, and made it very difficult for users to quit its ecosystem.

In investing, it pays to search in the right "neighborhood". In business, there clearly are "good" and "bad" industries – ones where high profitability is the norm and those company's barely scrape by. Tobacco, IT Services, Healthcare and Aerospace have historically been some of the most profitable industries, while Trucking, Real Estate Development and Oil/Gas have been some of the worst.[5] We believe industry profitability is an important starting point for investment analysis because profitability – as measured by return on invested capital (ROIC) – is one of the most persistent factors in corporate finance. High growth companies may become average growers over time as they saturate their markets, but high ROIC companies rarely become low ROIC businesses over time. Some reversion to mean does occur in profitability, but top quintile ROIC businesses do not become bottom quintile businesses and vice-versa.[6] Therefore, past profitability can be good predictor of future profits.

Durable competitive advantages, i.e. moats, help companies create and sustain high returns on invested capital (ROIC). We believe that only businesses that can generate abnormally high ROIC over long periods of time are worth investing in. What's more, at LRT, we look for companies that are protected by multiple interlocking moats – not reliant one factor for their success. Many software companies, for example, benefit from both high switching costs (training, integration process) and network effects (each user increase the utility of the software).

To learn more about how we think about selecting stocks and where we are seeing opportunities in the market, please contact us. We look forward to hearing from you and as always, thank you for your ongoing trust and support!

Lukasz Tomicki
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[5] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/EVA.htm
[6] https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/a-long-term-look-at-roic

Appendix I: Attributions and Holdings

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

Individual account results may vary to the timing of investments and fee structure. Please consult your statements for exact results.

Appendix II: 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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