LRT CAPITAL MANAGEMENT

THE VISION TO SEE
UNREALIZED VALUE

September 1, 2020

August 2020 - Performance Update

Dear Friends & Partners:

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

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

Markets were gripped by speculative frenzy during August. We know how this speculative craze will end – badly. We just don't know when it will end. You can rest assured we are staying far away from speculative securities as we try to navigate the market in an effort to generate portfolio performance and protect your capital. More on what happened during August is detailed below.

Market Madness

Stock markets around the world posted very strong returns during August but not all stocks performed equally well. In particular, technology stocks performed extraordinary during the month – so well as to bring back memories of the .com bubble of the late 1990s. To cite a few examples:

- **Tesla (TSLA)** rose by 74% during the month and ended the month worth over $464 billion, adding over $50 billion in "value" on the last trading day of August alone. Year-to-date +496%. The stock is up 11x over the past 12 months.[1]
- **Apple (AAPL)**, already the world's largest company by market value, rose by 22%, adding close to $100 billion in market value in the last trading day of August alone. Year-to-date returns +77%.
- **Carvana (CVNA)**, the loss-making retailer of used cars, rose by 39%, bringing year-to-date returns to +135%.

[1] See Appendix III for additional charts.

- **Nio, Ltd. (NIO)**, the loss-making Chinese electric car manufacturer rose +53%. Year-to-date returns +373%.
- **Nikola (NKLA)**, a company armed with a slick YouTube video[2] and big dreams of making hydrogen electric trucks, whose only revenue last year was $36k received from installing solar panels on its executive chairman's roof, rose 36%. The company is now valued at $15.5 billion. Year-to-date returns +295%.

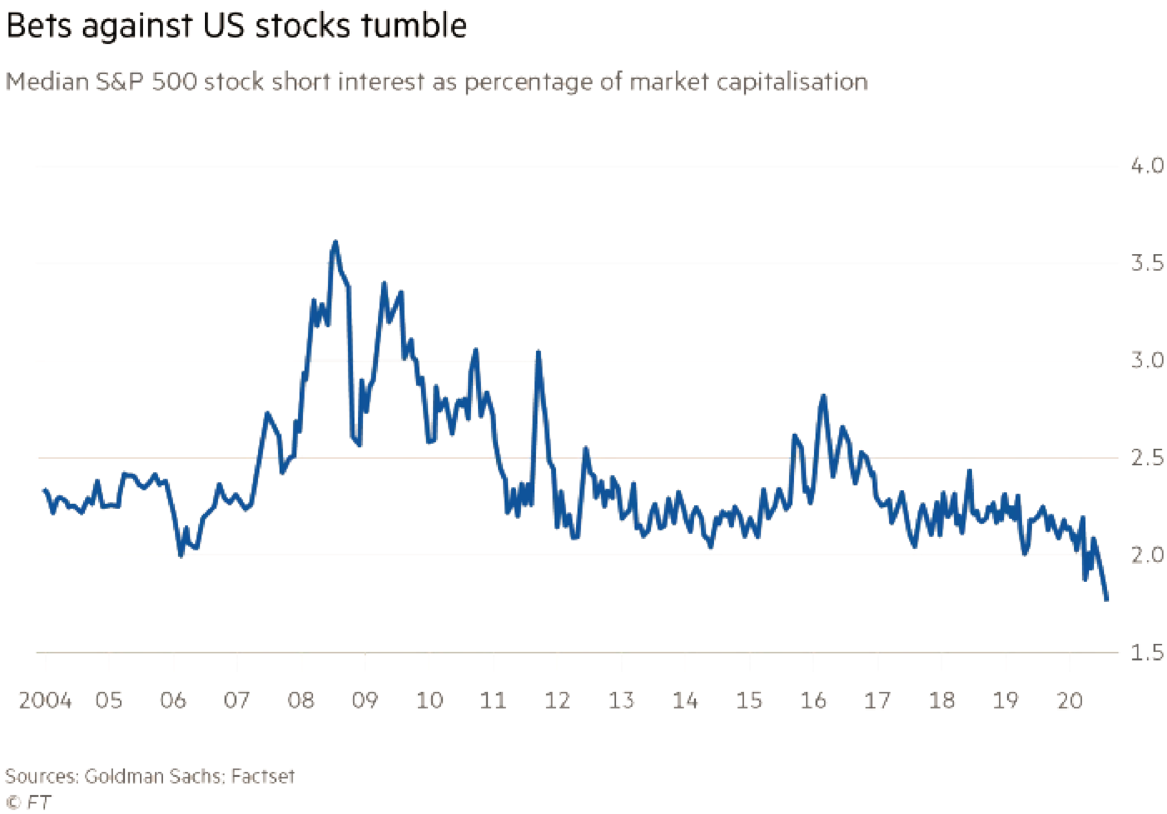
In almost all of the cases above, executives at the companies were selling stock as fast as they legally could. To paraphrase Shakespeare, "some are born great, some achieve greatness, some have greatness thrust upon 'em, and some take advantage of a gullible public but call it greatness."

In general, the more exciting a company's story and the more remote its future prospects, the better the stock price performed during August. With returns like those achieved by "story stocks", why bother with studying a company's business model, competitive advantage or doing such old-fashioned things like valuation? Take a company like WD-40 (WDFC), a stable, predictable, one might say, "boring" business that grows revenues at GDP+(1-2%). It is hard to construct a narrative around the company that results in a dramatic increase in value in the near future. Tesla (TSLA) on the other hand lends itself to all sorts of futuristic storytelling. 20 million cars per year with profits of 10k per unit? Why not. Add future "energy business" profits, self-driving robo-taxis, interstellar travel – and you can arrive at any stock price that you wish. Currently the world is awash in money and investors are choosing to believe in stories – however unlikely then may be.

Market records have been at least partially driven by strong retail investor participation through "commission free" trading platforms such as Robinhood.[3] I write 'free' in quotation marks because in investing nothing is ever free. Robinhood makes most of its money by selling its customers order flow to high frequency traders who then trade against Robinhood customers.[4,5]

Much of the recent market rally can be attributed to the Federal Reserve cutting interest rates and buying bonds at an unprecedented pace. As some have pointed out, the Federal Reserve has embarked on "Project Zimbabwe" – the creation of so much money that all asset prices must inevitability rise.[6] Investors have responded by bidding up prices for assets across the board, while short sellers have been hurt. In fact, "short selling", i.e., betting on lower prices has declined in popularity dramatically over the past 12 months to the lowest levels in close to two decades, as seen in the chart below.

[2] https://www.youtube.com/watch?v=qiB5MHnL7eU
[3] https://www.cnbc.com/2020/08/21/robinhood-is-having-a-moment-users-should-be-careful.html
[4] https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html
[5] https://fortune.com/2020/07/08/robinhood-makes-millions-selling-your-stock-trades-is-that-so-wrong/
[6] https://adventuresincapitalism.com/2020/04/05/project-zimbabwe/



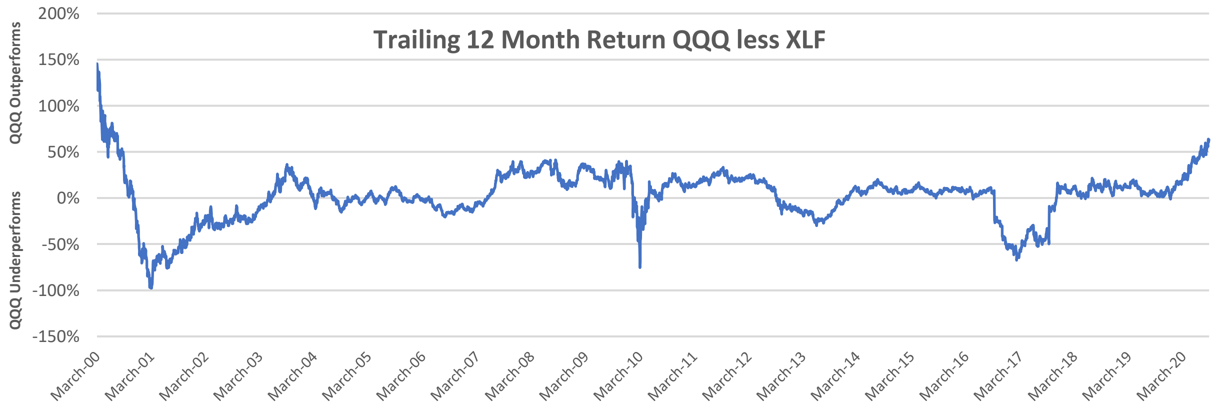
We believe that we are in a stock market bubble. Market bubbles start in doubt, grow in skepticism and die in euphoria. At LRT, we believe we are entering the euphoria stage. The new joke has become the manager promising 25% returns, to which prospective investors ask if that is "weekly or monthly?" Given the returns from Tesla (TSLA) or Carvana (CVNA) – their questions are justified!

During every bubble there are rational explanations proffered for why "it is different this time." The current intellectual justification for runaway prices comes in the form of ultra-low interest rates. Low rates forever allow investors to dream big and are used to justify higher stock prices today, as future cash flows are discounted at a lower rate, thus increasing their present value. On the face of it, the argument that lower interest rates should result in higher stock prices is reasonable, but it omits two important facts:

1. Lower interest rates imply low inflation and a slower pace of economic growth. This has the countervailing effect of depressing future profits for most companies.
2. The majority of value of many companies is being determined by cash flows 10 or more years into the future. The future, especially 10 years away, is uncertain, and the history of the world is full surprises. Competition, regulation, shifting consumer trends and creative destruction are often overlooked by investors. When 75% or more of a company's value comes from cash flows more than 10 years ahead you are placing a great deal of faith in an uncertain future. [7]

[7] See Appendix IV for an example.

Another way to look at this dynamic is to zero in on the performance of the Nasdaq 100 (QQQ) vs. the iShares Financial sector (XLF). Below is a twenty-year graph of their relative 1-year performance. We use the QQQ as a proxy for growth companies and the XLF as a proxy for value.



The chart above illustrates three points:

1) Nasdaq 100 stocks are outperforming financials by the largest margin since .com bubble.

2) Periods of outperformance are followed by periods of underperformance.

3) The bubble can still get bigger.

The outperformance of large, expensive growth stocks over the past twelve months is startling. Historically, investing in the largest, most expensive companies in the world is a losing proposition. At the time, the large companies always seem invincible, destined for success and valued as the great businesses they are. But competition, regulation and changing trends catch up with even the best businesses. The biggest and most successful companies in the world rarely stay that way. To illustrate this point, the largest companies in the world by market cap ten and twenty years ago are listed in the table below. As you can clearly see, investing in the largest companies in the world at that time was a terrible idea. Will this time be different?

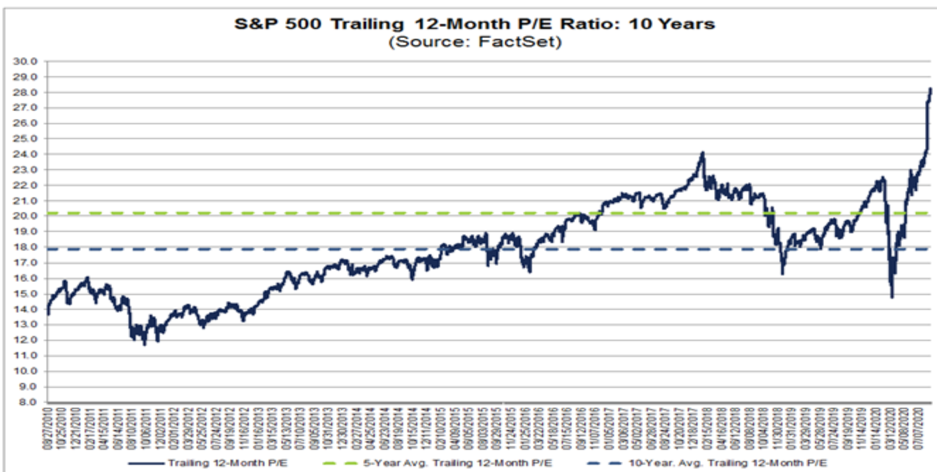
	Largest Companies in 2000		
	Name	**20-year return**	**Annualized**
1	General Electric	-79.11%	-7.53%
2	Cisco Systems	-19.20%	-1.06%
3	Exxon Mobil	78.87%	2.95%
4	Pfizer	75.08%	2.84%
5	Microsoft	915.83%	12.29%
6	Wal-Mart	327.96%	7.54%
7	Citigroup	-89.29%	-10.57%
8	Vodafone	-17.55%	-0.96%
9	Intel Corporation	7.45%	0.36%
10	Royal Dutch Shell	26.44%	1.18%
	median	**16.95%**	**0.79%**
	average	122.65%	4.08%
	S&P 500	**236.19%**	**6.25%**
	Long US T-Bond	**333.56%**	**7.61%**

	Largest Companies in 2010		
	Name	**10-year return**	**Annualized**
1	PetroChina	-56.13%	-7.91%
2	ExxonMobil	-3.54%	-0.36%
3	Microsoft	1115.17%	28.37%
4	ICBC	31.42%	2.77%
5	Apple, Inc.	1624.08%	32.94%
6	BHP Billiton	28.13%	2.51%
7	Wal-Mart	255.72%	13.53%
8	Berkshire Hathaway	177.11%	10.73%
9	General Electric	-37.82%	-4.64%
10	China Mobile	7.87%	0.76%
	median	**29.78%**	**1.31%**
	average	314.20%	7.36%
	S&P 500	**1550.94%**	**15.05%**
	Long US T-Bond	**286.25%**	**6.99%**

But wait, there's more! The sharp market rally we witnessed in August is but a continuation of trend that has been in place for some time, with large companies outperforming small ones, and expensive companies outperforming cheap ones. Historically the opposite is true with value normally outperforming growth and small caps outperforming large caps. Oh, how strange the last few years have been! The table below illustrates this trend.

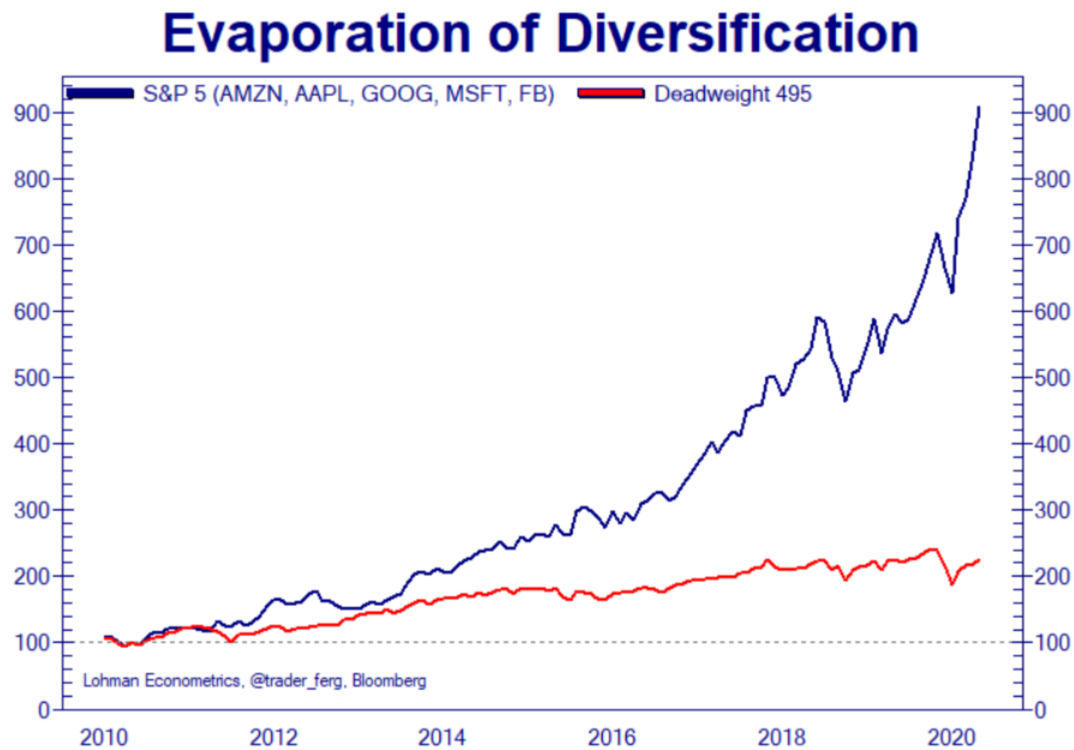
5-Year Annualized Returns[8]	Growth	Blend	Value	Growth Less Value
Mega	21.01%	15.59%	9.70%	11.31%
Large	18.79%	14.41%	8.60%	10.19%
Mid	13.42%	9.88%	6.04%	7.38%
Small	10.47%	7.71%	4.34%	6.13%
Mega Less Small	10.54%	7.88%	5.36%	

This market dynamic has presented any investor who cares about valuation with a dilemma: more and more of the market looks excessively expensive. Stocks are now by far the most expensive they have been in over a decade.



What's more, the market rally has been driven by a small group high growth, high ROIC companies, as seen in the graph below.

[8] Source: Sentieo, LRT Capital calculations.



We at LRT are the first to admit that high growth, high return-on-invested-capital companies are better investments than slow growth, low-return businesses. But everything has its limits. No company is so good that it deserves an infinite price. We believe we are currently beyond the valuations that are justified for many high growth companies – regardless of their superior business models and optimistic future prospects.

In summary:

- Speculative stocks are leading the market higher.
- Large growth stocks are outperforming small value stocks. This is the opposite of long-term historical patterns.
- The largest companies have historically been poor investments but have recently outperformed.
- Low interest rates have pushed up stock market valuations and are being used to justify high prices for stocks.
- Stocks tend to mean revert. After a period during which growth names outperform, value tends to shine and vice-versa.
- Growth has outperformed value by a margin only seen once before: during the .com bubble. After the bubble finally popped, value stocks outperformed growth by a wide margin over the next three years.

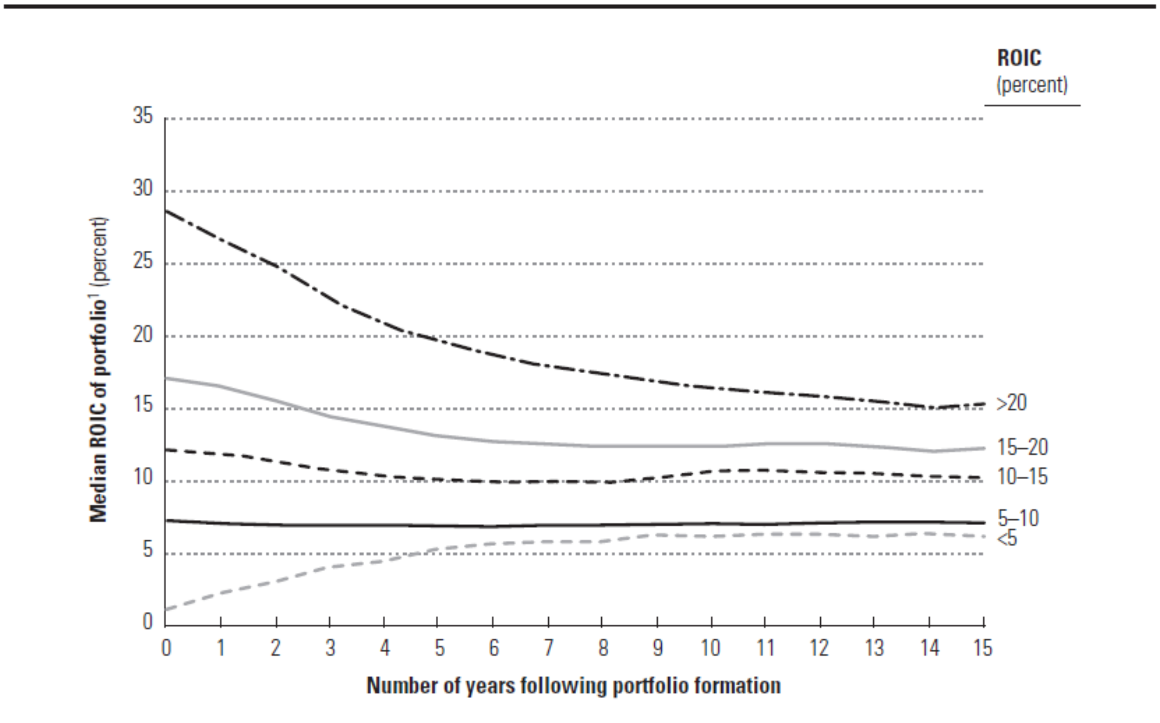
We are not market timers nor macro investors at LRT, but the evidence is mounting that the current market is full of speculative excesses. We do not use the word "bubble" lightly. We are positioned very defensively for what we believe will be an eventual rotation from growth into value stocks.[9] We believe that the outperformance of high-flying growth stocks will end in the next few months, and investors who focus on business fundamental will be well rewarded for their patience.

[9] See Appendix I for details.

Return-On-Invested-Capital (ROIC) and Why it Matters

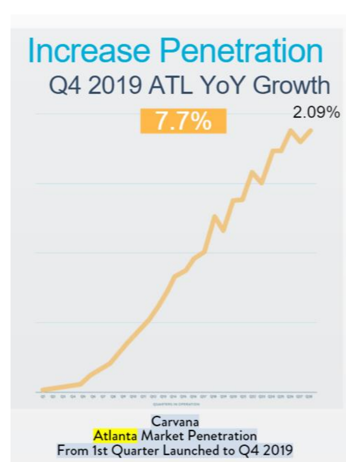
Returns on invested capital (ROIC) are the most important factor in identifying stocks in the LRT investment process. We focus relentlessly on ROIC because we believe it is the key factor in explaining long term stock performance. Simply put exceptional stock returns come from exceptional business returns. Importantly, ROIC, more than any other corporate financial metric that we know off, is persistent. While a degree of mean reversion exists, top quartile ROIC companies do not become bottom quartile companies and vice-versa. The intuition behind the persistence of ROIC is the fact that it is largely a function of a company's competitive advantage and its business model – things that are persistent and hard to change. The below graph helps to illustrate this point.

Nonfinancial Companies: ROIC Decay Analysis



[1] At year 0, companies are grouped into one of five portfolios, based on ROIC.
Source: Compustat, McKinsey Corporate Performance Center analysis.

Growth in topline revenue is also important, but it is much less predictable and more mean reverting. Companies run out of easy growth opportunities and it is extremely difficult to know when growth will slow down. For example, the very high valuation of Carvana (CVNA) is predicated on the company's ultra-fast revenue growth. Carvana's topline revenue grew by 101.48% in FY2019[10], but the company's oldest market, Atlanta, grew by only 7.7% YoY despite having only a 2% market share. For now, the company's growth rate is bolstered by entering new markets, but for how long? How long before the company's revenue growth collapses? This will clearly happen; the only question is when. When it does, and probably long



[10] Source: Sentieo.

before, the company's valuation will likely collapse as well, leaving investors nursing heavy losses.

Compared to growth rates, returns on invested capital (ROIC) are very persistent over time, allowing investors who make an effort to understand a company's business model and competitive advantage to anchor their analysis and **invest with high conviction**. Growth, on the other hand, is much harder to predict and inevitably declines over time. That is why we focus our efforts on identifying companies with durable competitive advantages, i.e. moats. The quantitative evidence of a moat is usually a persistently high ROIC.

We believe that investors chasing Tesla, Nikola, NIO and other hot growth stocks are likely to be disappointed in the months ahead, while those that chose a discerning approach that focuses company fundamentals will thrive. As always at LRT, we remain focused and disciplined in the execution of our repeatable investment process, that stresses long-term corporate fundamentals and identifying companies possessing **durable competitive advantage**s, **underappreciated growth opportunities**, and management teams with **strong records of good capital allocation**.

We look forward to hearing from you and discussing further where we see emerging opportunities.

Lukasz Tomicki
Portfolio Manager
LRT Capital

Appendix I: Attributions and Holdings

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

Net returns are net of a hypothetical 1% annual management fee (charged quarterly) and 20% annual performance fee. Individual account results may vary due to the timing of investments and fee structure. Please consult your statements for exact results. Please see the end of this letter for additional disclosures.

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.

Appendix III: Supplemental Charts

Tesla, Inc. (TSLA) Common Stock

Apple, Inc. (AAPL) Common Stock

Appendix IV: Terminal Value in Low Rate Environment

Example DCF Valuation: Free Cash Flow to Equity

10 Year US Treasury Yield[11]	0.68%
Equity risk premium	5%
Cost of equity	5.68%
Growth rate	12%
Terminal growth rate	2%

Year	Cashflow	Present Value	% of Total Value
1	100.00	94.62	1.62%
2	112.00	100.28	1.72%
3	125.44	106.28	1.82%
4	140.49	112.63	1.93%
5	157.35	119.37	2.04%
6	176.23	126.51	2.17%
7	197.38	134.07	2.30%
8	221.07	142.09	2.43%
9	247.60	150.58	2.58%
10	277.31	159.59	2.73%
Terminal Value	8,437.51	4,594.61	78.67%

Total Value	5,840.62
P/FCF	58.41x

1. Note that the "fair" P/FCF is very high under these assumptions.
2. More than 75% of the company's value is tied to cash flows beyond year ten.

[11] Source: Bloomberg.

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