November 6, 2020

October 2020 - Performance Update

Dear Friends & Partners:

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

October was a very volatile month that started off well but was ultimately a negative one for both of our investment strategies. The very sharp decline in the stock market during the last week of the month pushed us into the red – we believe this was largely a function of US election related uncertainty and a surge in worldwide Covid-19 cases. October was also an unusual month in that the stock market overall declined and closed at its lowest point of the month on the very last day of the month. Week to week results in the stock market can be volatile but we believe it is futile to try to time such swings. Investors who try to buy one week with the hope of selling out the next will find themselves with an unsatisfactory long-term result.

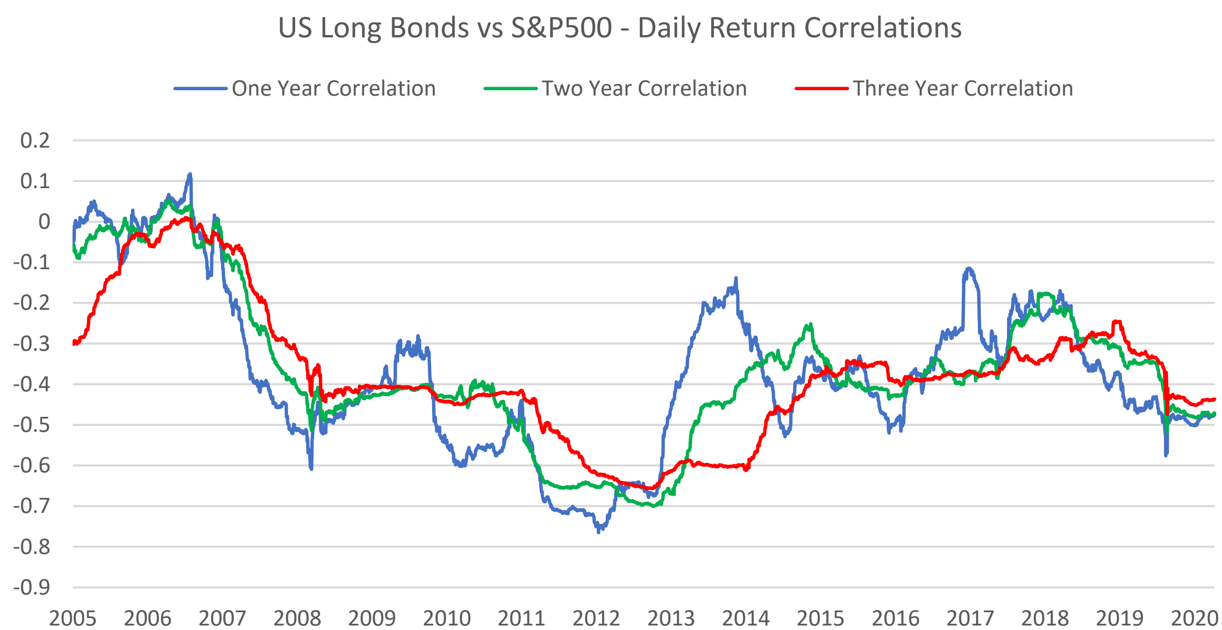
Importantly, as I write these words on November 5th, the LRT Economic Moat strategy is up over 10%, more than erasing October's losses.

Looking more closely at our results and their attribution for the LRT Economic Moat strategy[1], we can see that our core equity portfolio was down less than 1% during October, but it was the decline in US Bonds that really hurt us. Similarly, the LRT Market Neutral strategy we saw a very unusual divergence between different segments of the market, the result of which was that our hedges increased in value while our core equity longs decline. This is a very unusual occurrence but one we must occasionally accept. I remain confident in the ability of strategies to produce superior results going forward.

The negative results during October for LRT Economic Moat can largely be attributed to the negative performance of the US Bond market. As a reminder, in this strategy we have an allocation of approximately 1/3 of our assets to US Bonds. We hold bonds because they are a natural hedge to the equity market and tend to move in the opposite direction from stocks in most months. I write "tend" and "most months" very intentionally, because as you can see that was not the case in October. You may wonder if the current low interest environment or unusual Federal Reserve policies have impacted the usefulness of US Bonds as a hedge to the equity markets. The correlation between US Stocks and US Bonds is something we keep a close eye on. While the returns in October were unusual in that both stocks and bonds declined, the longer-

[1] See appendix I.

term pattern of negative correlation between these two markets is still holds. The chart below illustrates the rolling one-, two-, and three- years correlations along with summary statistics.



The data shows that the correlations between stocks and bonds remains negative. In fact, the correlation is both negative and relatively strong over the past 1, 2 and 3 years. This relationship plays an important role in our investment strategy and we will always continue to monitor it closely.

	1-Year	2-Year	3-Year
min	(0.7654)	(0.7003)	(0.6568)
20% percentile	(0.5031)	(0.4671)	(0.4790)
40% percentile	(0.4137)	(0.4103)	(0.4133)
60% percentile	(0.3206)	(0.3487)	(0.3688)
80% percentile	(0.1438)	(0.2184)	(0.2837)
max	0.1177	0.0529	0.0104
mean	(0.3443)	(0.3540)	(0.3741)
median	(0.3746)	(0.3861)	(0.3880)
current	**(0.4754)**	**(0.4715)**	**(0.4370)**
current percentile	**28.40%**	**18.40%**	**29.20%**

The Joys of a Bearish Consensus

With all the daily news it is easy to forget what really matters in the long-term for stock returns: corporate earnings. On this front, things have been stellar. US companies are reporting earnings largely ahead of expectations. From the Q3 earnings that we have seen so far it is clear that estimates have been too low – with most companies beating them handedly. Many companies in our portfolio are reporting fantastic results. We believe this sets us up for strong performance in the months ahead as investment analyst are forced to revise estimates upward and the election related uncertainty fades away. To cite a few examples of Q3 results:

- **The Clorox Company (CLX) –** the maker of household cleaning products reported sales that rose 27% year-over-year; EPS +66%; cash from operations +41%; and expanding margins. The company also raised full year guidance. Management stated that they are also increasing advertising spending in order to take additional market share.

- **Church & Dwight Co. Inc. (CHD) –** the company famous of its “Arm & Hammer” baking soda brand, Trojan condoms, and Orajel, reported sales +13.9% year over year; EPS +6.1% (affected by a number of one-time items); cash from operations +29.3%;

- **Domino's Pizza, Inc. (DPZ) –** whose main product is in the company’s name, reported sales +14.8% year over year; EPS +21.5%; cash from operations +14.1%; The company also raised its guidance for the year.

These are just some of the highlights from our portfolio companies, most of which are reporting stellar results in the context of a global economy still suffering from the Covid-19 pandemic. You may have noticed that the companies we are primarily invested in are quite boring businesses – not exciting tech high-fliers. We believe many tech companies today are trading at elevated valuations with a high degree of speculative activity in their shares. We are steering clear of any such companies.

We focus on business models and understanding industry dynamics, not chasing the latest high-tech fad. Clorox, Church & Dwight, Domino’s Pizza – these are businesses we can understand. On the other hand, do the “investors” who speculate on shares of Fastly (FSLY), really understand that the heck that company does, much less what the industry will look like in five years’ time?[2]

Technology shares, broadly speaking, are in speculative bubble, yet many ordinary and “boring” businesses are trading at reasonable valuations and are continuing to grow their earning power, despite the Covid-19 crisis. These types of shares are where our portfolio is currently concentrated in. We expect these types of companies to be resilient to economic shocks, but more importantly, we expect their shares to be resilient when the tech-mania bubble finally pops.

2020 has been a year from hell, but as they say: if you are going through hell… keep going. There is light at the end of the tunnel, and I truly expect we will exceed our high-water mark by early 2021. Thank you for your continued investment and ongoing support!

Lukasz Tomicki
Portfolio Manager
LRT Capital

[2] Fastly recently reported results that missed expectations. The stock promptly lost 1/3 of its value. It still trades at 25x sales. In the past 12 months the company generated $8.1 million in cash flow from operations, yet has an enterprise value of $7.2 billion as of 11/4/2020.

Appendix I: Attributions and Holdings

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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.

Disclaimer and Contact Information

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