December 1, 2020

November 2020 - Performance Update

Dear Friends & Partners:

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

November was a very strong month for both of our investment strategies. While we never make short term market calls at LRT, in last month's letter we discussed the "Joys of a Bearish Consensus"[1] – the negative market sentiment that prevailed at the end of October. Since then, the US Presidential election uncertainty has been resolved, coupled with the very positive news relating to the Covid-19 vaccine. This changed the market sentiment and pushed equity markets around the world higher. In fact, November 2020, was among the best months for broad stock market indexes in recorded history. This past month demonstrates the dangers of waiting to invest due to "uncertainty". Investors who are putting money to work only now because they feel more "certain" have missed out on this historical rally.

Our November results are particularly good because our strategies faced several headwinds during the month. In our portfolios we are tilted towards mid- and large-cap companies of high quality and relatively low volatility (low-beta). Yet, during the month, it was small-cap stocks, high-beta and "junky" (speculative) companies that surged the most, while the type of companies that we at LRT favor, lagged. This makes our November result all the most positive. For a complete attribution report, see Appendix I.

At LRT, we are playing the long game, avoiding speculative investments and focusing relentlessly on company fundamentals. Our portfolio companies are resilient, have high levels of profitability and clear competitive advantages. We expect our companies and their stock prices to hold up relatively well when the tide of speculation that is currently engulfing Wall Street finally goes out. We have more confidence than ever in the sustainability and strong future prospects for both of our strategies. We expect both of our funds to exceed their high-water marks by the end of Q1 next year. We also expect the LRT Market Neutral strategy to post significantly better results next year as improvements we have made during the year begin to pay off.

[1] https://www.lrtcapital.com/wp-content/uploads/2020/11/2020-10-October-Performance-Update-Public.pdf

We continue to add new investment partners and receive follow on investments from existing investors.[2] We thank you for your patience and support in what has been a very difficult year. We believe that your trust and perseverance will be rewarded in the months ahead.

The Dash for Trash

In early September a shift occurred in the market, and since then the rally in stock prices has been largely driven by junky companies and speculative investing: electrical-vehicle-anything, special purpose acquisition companies (SPACs), bankrupt businesses (Hertz), e-commerce-anything and Bitcoin. To name just a few examples: Tesla (TSLA), everyone's favorite electrical car company, now has a market capitalization in excess of $550 billion[3] – suggesting that it is already one of the world's most successful businesses. Hedge funds that once sold Tesla stock short, betting on the company's downfall, are now "playing" the stock on the long side – having completely thrown in the towel on trying to analyze fundamentals. SPACs – blank check companies created solely to acquire some other company[4] – have become the newest speculative vehicle. Bitcoin has surged to new record highs.[5] Nikola (NKLA), a company promising hydrogen powered trucks – with no revenue and no trucks – is being valued at over $8 billion. The list of such speculative excesses goes on and on. We believe we know how this speculative period will end for "investors" who try to play this game – badly. We just can't know exactly when it will end.

The valuation of many high growth, but money losing, companies began the year at dizzying highs and has since soared to levels that are completely untenable. The Covid-19 pandemic created a perfect storm for many of these companies – reinforcing trends that had previously existed. Companies operating in the virtual world were not only unhurt by the pandemic but actively helped by it. Amazon was helped at the expense of physical stores, Peloton at the expense of gyms, Zoom at the expense of Marriott, and Netflix at the expense of movie theaters. Covid-19 shut down many of these physical competitors thus creating additional demand for digital goods and services. We believe 2021 will bring a reversal of many of these trends as consumers once again embrace experiences in the physical world and the Covid-19 pandemic retreats.

Many of the high growth companies that have soared during 2020 are investing for growth and may eventually succeed as businesses, but that does not mean that investors in their stocks will do well. We keep hearing and reading that stock XYZ will "grow into its valuation" and therefore investors should not be worried. This is baloney. Investors are not purchasing shares to sit on them for years while a company "grows into the share price" – they are speculating on prices continuing to rise rapidly and will dump those shares just as fast when the trend changes. You can lose a lot of money investing in a business if the price you pay is too high, even if the business is ultimately successful – something we wrote about in more detail in our February 2019 letter to you when we coined the phrase "Bubble Basket".[6] Take for example Cisco, Inc. (CSCO), the maker of networking hardware. In late 1999, the company's market cap exceeded $500 billion. In 1999, the company earned $2.1 billion on revenue of $12.2 billion. In 2020, it made over $11.2

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[2] New investors should review our investment philosophy laid out in detail in Appendix II.

[3] As of 11/30/2020. Source: Sentieo.

[4] Why doing "deals" should create value when the historical evidence suggests M&A destroys value is anyone's guess.

[5] https://www.coindesk.com/despite-12-crash-bitcoin-looks-set-to-make-highest-monthly-close-ever

[6] https://www.lrtcapital.com/wp-content/uploads/2019/10/2019-02-February-Performance-Update-Public.pdf

billion on $49.3 billion in revenue. Over a period of twenty years, revenue grew by a factor of 4.4x and profits by 5.3x – a huge success by any measure. So how did investors in the company's shares do over that time period? Today the company's market cap stands at approximately $180 billion[7] - a loss of 64%. Investors lost nearly 2/3 of their money despite the company performing extremely well. Even if you include the dividends that the company has paid along the way the loss still exceeds 20%. How many "Cisco(s)" are among today's high growth tech darlings? Will Datadog (28.7x P/S), Snowflake (160.8x P/S) or Tesla (17.8x P/S) ever earn enough profits to justify their stock prices?

As the memory of the .com bubble and subsequent crash fades, explanations are offered why "this time is different". Most of these focus on the persistently low interest rates around the world, better business models and the transformative nature of technology. We believe that all of the above are true, but it doesn't change the fact that the price one pays for an investment matters – and we believe that the prices being paid for many technology companies today far exceed what is justified. Warren Buffett once said that *"it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."*[8] – a quote that today appears to have been misinterpreted as "it is better to buy a wonderful company at ANY PRICE". One might call this quality-at-any-price (QAAP) investing. Of course, it is better to invest in competitively advantaged, fast growing companies with excellent management teams, than in those competing in commoditized markets, facing shrinking demand and managed by crooks. Yet, we believe that in today's market, it is stock price performance that is driving the narrative about the "greatness" of many of these companies.[9] When stock prices falter, many of these businesses will be revealed as being far less "great" than commonly believed.

In financial markets trends can grow and garner the feeling of inevitability. In the words of George Soros, market trends are tested, and each successful test reinforces the trend – until the gap between expectations and reality can no longer be sustained and it collapses.[10] The initial success of a few companies brings about higher valuations, more investment and ever rising stock prices – a process we believe is well underway with many high growth tech stocks today. For example, Shopify, Inc. (SHOP), is a wonderful business – competitively advantages, growing quickly in what appears to be a huge addressable market and led by a truly exceptional CEO/Founder, Tobi Lutke – we have nothing but admiration for what the company has achieved. But the prices paid by investors ultimately matter to returns – just as those who invested in telecom in 2000 or financial in 2007 have learned the hard way. We believe investors paying 45x sales for Shopify in 2020 will suffer a similar fate. Expectations for the company are so high, that investors are almost certainly going to be disappointed.

To reinforce the point that the price you pay for something matters – let us consider lottery tickets. There are contexts within which buying a lotter ticket makes sense. The price is usually low, and if you win the Powerball lottery it can be a life changing event. Yet investors in companies such as Tesla (TSLA), today face what we might dub the "inverse-Powerball" dilemma. With a market capitalization in excess of $550 billion, Tesla is the 8th largest company in the World – already priced as if it dominates the transportation, solar panel and self-driving taxi industries. This is very unlikely to happen but not outside the realm of possibilities. But what kind of upside can investors expect if Tesla meets these expectations? Perhaps the

[7] Source: Sentieo.

[8] Source: Berkshire Hathaway 1989 Letter to shareholders

[9] The tendency of stock prices to drive the narrative around a business is well documented. For more see "The Halo Effect: . . . and the Eight Other Business Delusions That Deceive Managers", available on Amazon https://www.amazon.com/Halo-Effect-Business-Delusions-Managers/dp/1476784035

[10] https://www.amazon.com/Alchemy-Finance-George-Soros/dp/0471445495/ref=sr_1_2?crid=236I6W14MLQ1D

stock can double or triple from here – good but not exactly a Powerball type of payoff. And what if the company does not meet its lofty expectations? The downside is huge. In other words, at these valuations, investors must hope to win the Powerball just to avoid a huge loss. Many tech stocks are in the same inverse-Powerball category: they have nearly become "return-less risks".

Low interest rates, social media, and the gamification of investing through apps such as Robinhood[11] have led to a speculative frenzy. It is no wonder that Dave Portnoy, a sports gambler, has emerged as the face of this new era[12] - "investing" during live streamed events by picking stock symbols from Scrabble letters and going as far as to declare himself a better investor than Warren Buffett. The year-to-date performance of consumer facing tech company stocks has misled many people into thinking that the only thing one must do in order to get rich is to buy Peloton (PTON), Tesla (TSLA), and Zoom (ZM). This behavior has spread to many professional investors too. Faced with a stock market where fundamentals no longer seem to matter, investment managers have begun to gamble as well. We know of a self-declared value investor who has begun buying Tesla for his client portfolios and waxing poetically in his investor letters about the company's long growth runway for reinvestment and how "they are just getting started". This is of course intellectually dishonest yet has proven profitable year-to-date. An honest assessment would be to say that he is gambling and chasing short-term returns – alas, such a declaration would make it possible for his clients decide if they really want to participate. Many people will lose money when the tide of speculation goes out. In fact, many have already lost their money – some have even lost their lives.[13] You can rest assured that no such "style drift" is occurring at LRT.[14]

It gets worse. Investment analysts are no longer analyzing anything. Many investment "research reports" that we have read over the past few months justify overvalued stock prices by pointing to other overvalued companies as "comparables" instead of attempting to estimate the future cash flows needed to support the stock price. What's more, a speculative mania has gripped Wall Streets – as evident by the large number of SPACs recently created. SPAC stands for special purpose acquisition company – a company created with the sole purpose of acquiring another company. Investors have allocated over $30 billion dollars to such SPACs in 2020 in the expectation that they will do further unspecified "deals". No mind that the median SPAC has delivered a -29% return to investors since 2015.[15]

Particularly revealing is a recent comment from Alicia Levine, chief market "strategist" at BNY Mellon Investment Management who said in July, referring to tech stocks: *"I think we're all scratching our heads, but the market is telling me you've got to be in it."*[16] Such "insights" will probably be rewarded with millions of dollars of annual bonus. For those of us old enough to remember, this is immediately reminiscent of the

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[11] The mythical Robinhood stole from the rich to give to the poor. The company in question can more aptly be described as "reverse Robinhood", because it sells the order flow from its thousands of small clients to high frequency trading firms such as Citadel Securities who then profit by trading against Robinhood clients. Citadel Securities is owned by Ken Griffin, an American investor and entrepreneur with an estimated net worth in excess of $15 billion.

[12] "Barstool Sports Dave Portnoy is Leading An Army of Day Traders" - https://www.bloomberg.com/news/articles/2020-06-12/barstool-sports-dave-portnoy-is-leading-an-army-of-day-traders

[13] https://www.forbes.com/sites/sergeiklebnikov/2020/06/17/20-year-old-robinhood-customer-dies-by-suicide-after-seeing-a-730000-negative-balance/?sh=6732f9051638

[14] See Appendix I for our top portfolio holdings.

[15] https://www.renaissancecapital.com/IPO-Center/News/71816/Updated-SPAC-returns-fall-short-of-traditional-IPO-returns-on-average

[16] https://www.bloombergquint.com/markets/asian-stock-futures-point-to-modest-declines-markets-wrap

comments made by Chuck Prince, former CEO of Citibank in 2007, who then said: "When the music stops […] things will be complicated. […] but as long as the music is playing, you've got to get up and dance." Since those words were spoken, thirteen years ago, Citibank (C) stock price has decline 88%. It has been an expensive "dance" for the company's shareholders indeed.

Over the past twenty years, investors in Cisco (CSCO) lost 64% of their money. At the same time, one could have invested instead in the boring and unglamorous waste management industry. Three large public companies were available for investment: one could have picked Waste Management (WM), Republic Services (RSG) or Waste Connection (WCN). Since then, investors in those shares made 11.5x, 15.4x, 42x their money respectively.[17] Past returns are no guarantee of future results, and we certainly don't think history will exactly repeat itself. But we think it might rhyme.

We are in the middle of a speculative bubble of historical proportions. At LRT, while we understand the appeal of high-tech growth stocks, we are staying far away from speculating in them. We continue to focus on profitable, easy to understand, and "boring" businesses such as Clorox (CLX), Church & Dwight (CHD) and McCormick (MCK). We regard stocks as claims on the cash flows produced by a business that can one day be distributed to shareholders. In our investment strategy we seek to own companies which we believe will produce high cash returns on capital and reinvest those cash flows at high incremental rates of return.

This is our last letter to you before the Christmas Holidays. We want to wish you and your families the best of health and luck in the next year. In 2021, we will continue to focus on identifying high quality companies to invest in and we look forward to a bright future. We believe that investors who see past the crazy speculative mania that we find ourselves in and focus on company fundamentals will find themselves well rewarded in the year ahead.

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

Lukasz Tomicki
Portfolio Manager
LRT Capital

[17] Source: Sentieo.

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.

Disclaimer and Contact Information

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