February 3, 2021

January 2021 - Performance Update

Dear Friends & Partners:

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

January was a strange month overall. The equity component of both of our strategies outperformed the S&P500 during the month, but our hedges dragged down overall returns.[1] The Economic Moat Strategy returned approximately -1% during the month due to the sharp decline in long term US Treasuries, while our long/short Market Neutral Strategy delivered -6.44% - an unsatisfactory result to be sure, but far better than many other long/short funds during the month[2,3,4] – once again it was the performance of our hedges that contributed to the negative returns. The performance of the Economic Moat Strategy was negatively impacted by our US bond holdings as bonds sold off sharply during the month on fears of more spending plans from the Biden administration, especially in wake of the Senate victories in Georgia.

In Market Neutral, the negative performance was drive by the very unusual behavior of our hedges which consist of mid-cap and small-cap index ETFs. During January, the S&P500 returned -1.02%, mid-caps returned between 1.4% and 1.5% (depending on the index you look at), and small caps returned between 4.85% and 6.17% (again, depending on the index). In fact, small caps have outperformed the S&P500 sharply since September and this has acted as a headwind to our strategy. Periods of small and mid-cap outperformance do occasionally occur, but the magnitude of this small cap outperformance has been quite stunning over the past few months. In January the relative returns of these indexes reached extremes, as a speculative fever gripped Wall Street. What was the most predictive variable for a stock's return in January? The share price itself, with the lowest priced stocks and the smallest companies performing the best.[5]

How extreme was the outperformance of small caps in January? We looked at rolling 30-, 90-, and 180-day returns for various small cap ETFs and compared them to the rolling returns of the S&P500 (SPY) ETF. The results are summarized in the table below. Simply put, the outperformance of small cap indexes

[1] See Appendix I for details.
[2] https://www.wsj.com/articles/melvin-capital-lost-53-in-january-hurt-by-gamestop-and-other-bets-11612103117
[3] https://www.bloomberg.com/news/articles/2021-01-28/dan-sundheim-s-20-billion-d1-capital-loses-about-20-this-month
[4] https://www.bloomberg.com/news/articles/2021-01-28/viking-global-hedge-fund-down-single-digits-in-market-tumult
[5] https://www.wsj.com/articles/when-investors-forget-fundamentals-the-market-is-broken-11611055800

over the recent past is the sharpest it has ever been. The good news from all of this is that the relative outperformance of small caps is almost certainly coming to an end soon. Periods during which one part of the market outperforms are usually followed by a period when that very segment underperforms. In fact, so far, as of February 3rd, our Market Neutral strategy has regained much of its lost ground.

Pair	Period	Score	Percentile
IJR (% return) less SPY (% return)	180	23.70%	99.49%
IWM (% return) less SPY (% return)	180	26.19%	99.78%
IJR (% return) less SPY (% return)	90	21.49%	99.81%
IWM (% return) less SPY (% return)	90	20.29%	99.67%
IJR (% return) less SPY (% return)	30	6.85%	98.38%
IWM (% return) less SPY (% return)	30	5.18%	96.57%

Many small cap stocks rose spectacularly during January, particularly in the last two weeks of the month. A small number of stocks appear to have been manipulated, i.e. "short squeezed" – producing large losses for many popular hedge fund strategies. As many funds lost money on their short investments, they sold their long investments, a process commonly referred to as "de-grossing" – a very fancy term for "losing lots of money fast". In fact, according to data from Morgan Stanley, January's de-grossing was one of the largest on record.

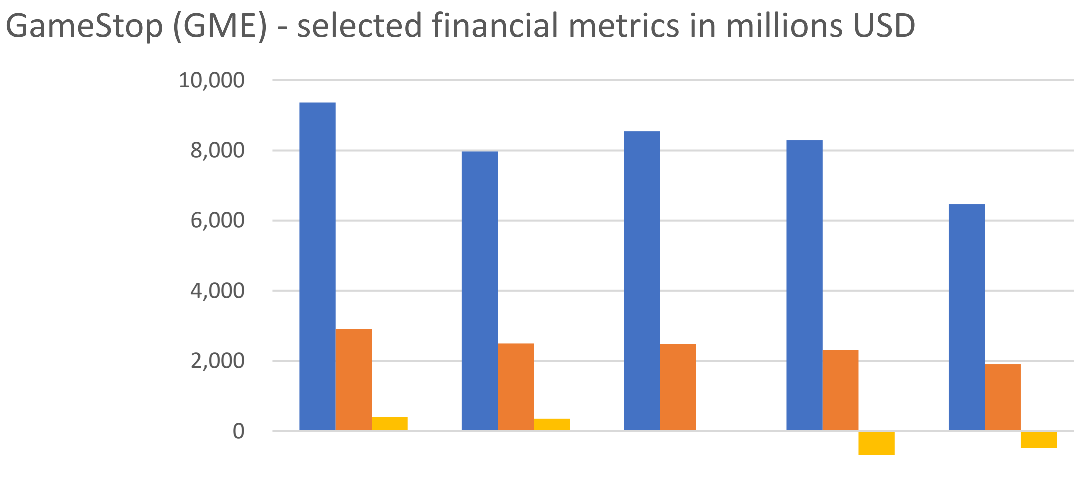
Figure 1: Rapid De-Grossing (i.e. Selling Longs + Covering Shorts) This Week – Global Flows Across Strategies

The events in January demonstrate just how much risk there currently is in the markets, and how dominated the market has become by "flows", "technical" and factor investing – as opposed to a disciplined analysis of company fundamentals. If a 1% decline in the S&P500 can cause this amount of de-grossing, what would have happened if the market lost 10 or 15%? - something that happens in the stock market with regularity. Many investors are so leveraged[6] after last year's effortless money that even a small correction or deviation from market normality can cause an avalanche of selling. Rest assured that we are not in that position – our portfolio is concentrated in predictable and safe companies.

[6] One indication of leverage and how much risk people are assuming are high yield bond spreads. Not surprisingly, they are at the tightest level ever. See Appendix III for more details.

GameStop (GME)

During the month we received several questions that can all be paraphrased as "what the heck is happening to GameStop?". Let me address that. GameStop (GME) is a mall-based retailer of video games. The company has been in a slow decline for a long time as game distribution has moved more and more online, but Covid-19 really accelerated the company's fall. Why go to the mall to buy a game console when you can get it on Amazon, at Walmart or dozen other places? Why go and buy physical game discs when you can download the games over the Internet? The people most compelled to go in-person were those with slow internet connections and those wanting to sell their old games and buy discounted second-hand games – an ever-shrinking demographic. This was reflected in the company's financial results.[7]



	FY2016	FY2017	FY2018	FY2019	FY2020
Revenue	9,364	7,965	8,547	8,285	6,466
Gross Profit	2,918	2,500	2,485	2,308	1,909
Net Income To Common Shareholders - As Reported	403	353	35	(673)	(471)

By April 2020, the company's share price had declined under $4/share. However, at the time, the company had over $9/share of tangible book value – primarily inventories and other working capital items. At the time, the investment case was clear and reasonable: if management could slow the deterioration of the company's core business, close stores, liquidate inventory and buyback shares with the proceeds, shareholders would do well even as the business declined. This was a classic case of a "cigar butt" investment – there was one last puff to be had but this puff was free. This opportunity had not gone unnoticed. Value investor Michael Burry, of "The Big Short" fame, who acquired a large number of shares, urged management to aggressively buyback shares.[8] Later, in H2 2020, Ryan Cohen, of Chevy.com fame, was reported to have acquired a large stake in the company as well.

It was around this time that the Reddit group "WallStreetBets" became interested in the company for other reasons. Members of the group speculated that they could drive up the share price and profit from it – a so called short squeeze. GameStop shares were in fact heavily shorted – creating the opportunity for a short

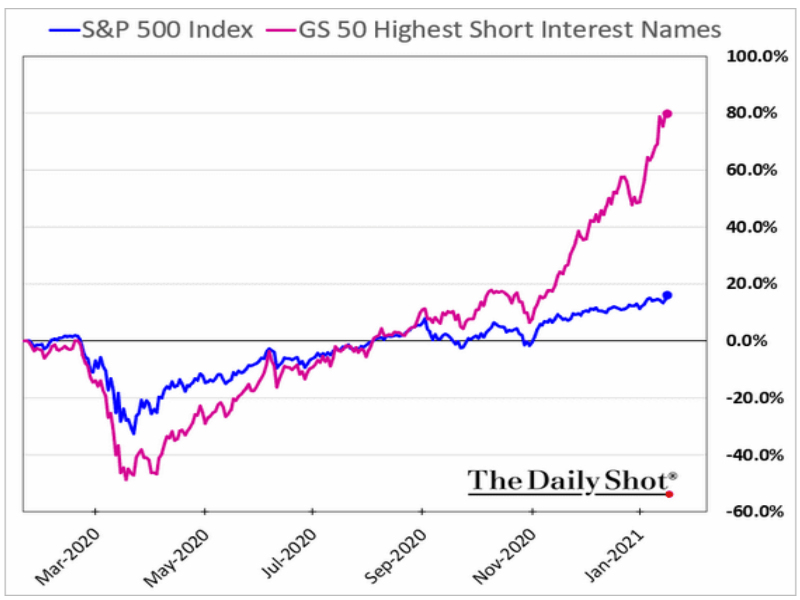
[7] Source: Sentieo.

[88] https://www.businesswire.com/news/home/20190819005633/en/Scion-Asset-Management-Urges-GameStop-to-Buy-Back-238-Million-of-Stock-with-Cash-on-Hand

squeeze. I will spare you the discussion of the mechanics of short selling, short squeezes, gamma, call-put parity, "tendies" and "diamond hands". Suffice it to say that as the stock price of GameStop rose at the end of 2020 and into early 2021, encouraged by Ryan Cohen buying into the stock, the price dynamic took on a life of its own – completely disconnected from reality. The rising share price caused heavy losses for those betting on the company's demise, i.e., "the shorts" and at least temporarily, big gains for those gambling on the stock going up. Let us not forget that GameStop is a dying mall-based retailer of video games, not the next Tesla or Amazon. Unless the company can turn around its fortunes, the stock price will likely collapse – something that as of February 3rd, appears to have already begun (the stock is currently trading under $100 down from a high of over $400 in late January).

Why have I spent so much time and ink on GameStop? I believe there are important lessons to be learned from this saga. GameStop for a few days truly ignited the public's imagination and generated enormous media attention. When Robinhood, the "free" online trading platform stopped allowing purchases of GME shares it created so much public anger that it even united Alexandria Ocasio-Cortez (AOC) and Ted Cruz.[9] The media was so obsessed with GameStop that anyone with even a tangential opinion was trying to make GME part of a bigger narrative. Instead of calling it a simple speculative bubble and short squeeze, GME became a symbol of class warfare.[10] Even convicted fraudster Jordan Belford, on whose exploits the movie "Wolf of Wall Street" is based, was invited to comment on GameStop.[11,12] Truly, why are we honoring this man with media attention? Would CNBC invite Bernie Madoff, if he was still alive, to give investment advice? Have we run out of normal human beings?

Secondly, the GameStop story helps illustrate an important consideration about investment strategy design. At LRT, we are often asked, why we don't short individual stocks, so called "alpha shorts". The squeeze in GME (and to an equal degree BBBY, KOSS and other crappy companies) during January, almost put Melvin Capital out of business.[13] The firm was saved by an emergency infusion of $2.75 billion from Point72 and Citadel – reportedly on tough terms.[14] D1, Viking, Point72, Citadel and others… the list of casualties from January's short squeeze is long. And these are truly



Stocks with the most "short interest" performed the best during January.

[9] https://www.nytimes.com/2021/01/31/us/politics/gamestop-robinhood-democrats-republicans.html
[10] https://www.businessinsider.com/mark-cuban-thanks-wallstreetbets-advises-hold-gamestop-stock-robinhood-reddit-2021-2
[11] https://www.youtube.com/watch?v=On4g1uj71zc&ab_channel=SkyNews
[12] https://www.hollywoodreporter.com/news/jordan-belfort-encourages-gamestop-traders-via-wolf-of-wall-street-scene
[13] https://www.cnbc.com/2021/01/27/hedge-fund-targeted-by-reddit-board-melvin-capital-closed-out-of-gamestop-short-position-tuesday.html
[14] https://www.wsj.com/articles/citadel-point72-to-invest-2-75-billion-into-melvin-capital-management-11611604340

some of the smartest investors in the world. Individual shorts carry with them enormous risks. The GME story illustrates just how big these risks can be.

Third, the question of hedging and leverage. If you have a long book you can hedge it and increase your leverage. The more “precise” your hedge is, the higher leverage you can potentially assume. In fact, as you make your hedge more and more precise, you are likely going to reduce returns – making higher leverage a necessity. Having a more “precise”, i.e. “better” hedge should allow you in theory to isolate the source of return that you are targeting and where you supposed have an edge, thus a more hedged strategy should produce a more consistent and predictable return stream – music to the ears of potential allocators. So, the tradeoff is between improving the hedging and increase leverage on one hand and operating with lower leverage and a less perfect hedge on the other. Sophisticated funds, such as Citadel, use complex multi-factor models for hedging purposes and therefore operate with very high leverage. The unseen danger here is that all the parameter estimates for your hedging strategy come from past data and by increasing leverage one makes themselves susceptible to rare out-of-sample events that may not exist in historical information. To paraphrase Nassim Taleb – you are creating fragility through increased leverage. Hence, we at LRT, believe that you should err on the side of less complexity, less “perfect” hedging and lower leverage.

Finally, the GME saga puts in perspective the question of risk management. We are often asked about this topic – and there are many complex answers: position size limits, industry concentration limits, factor exposures, volatility regime management, hedging and rebalancing policies, … etc. But I think the GME episode simplifies things to this: **risk management is about never putting yourself in a position where you could lose everything**. This is easy to say, but hard to learn – I believe it can only truly come from one’s experiences. Risk management, therefore, is not a function of intelligence but rather of character. In fact, intelligence can be your enemy when it comes to risk management, because the mind often works to convince smart people that they wont fall into the same traps that others will. After all, the easiest person to fool is often oneself. Warren Buffett once said that when it comes to investing it is better to have an IQ of 130 but act as if it was 110, rather than have an IQ of 150 but act as if it is 180. This attitude, of humility, is one that I fully subscribe to.

The Year Past

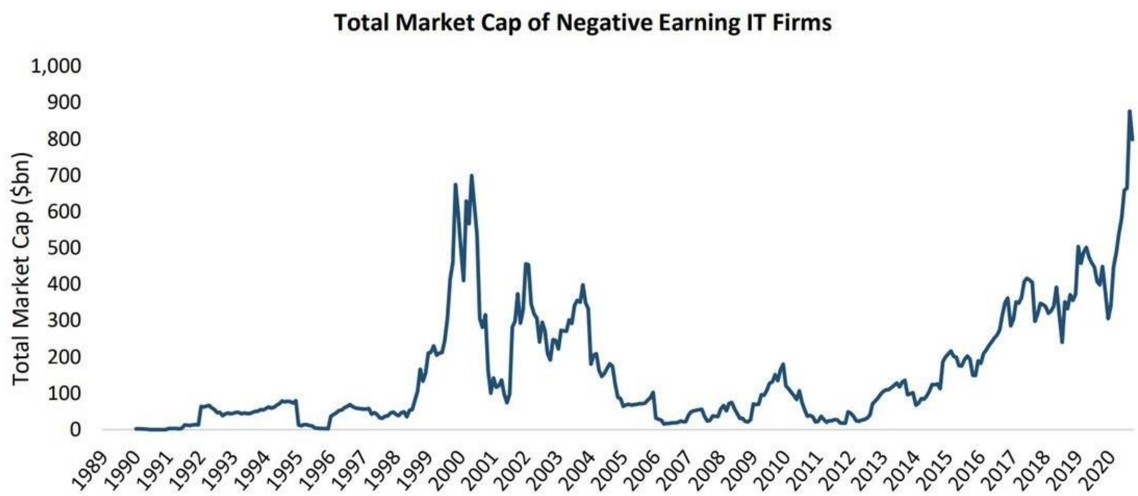
As we are on the topic of humility the year past is worth discussing. 2020 was the worst year in the history of our investment partnership. During the March 2020 crash we liquidated a substantial portion of our investments within days of the market bottom and didn’t fully reinvest until the second half of the year. This resulted in our fund sharply underperforming the S&P500. Had we done nothing at all, we estimate we would have generated returns of more than double the S&P500 in 2020.

In hindsight, the Fed intervention in March 2020 saved the market. This was impossible to know when we acted to reduce our positions. Things could have turned out quite differently. It was possible that the market would have crashed further, just like it did in 1987 when broad indexes have been declining for several weeks, culminating in a crash of over 20% in a single day. It was this consideration that led us to reduce risk when we did. The March episode prompted important changes to our portfolio construction approach which will make us better prepared for future downturns. It also illustrates the importance of staying humble in the face of the unknown. As the saying goes: hubris sells, but humility survives. In investing, in order to succeed in the long term, you must first survive. It is my ambition to deliver to you “hall of fame” type long term returns, but I will always prioritize protecting your hard-earned capital in the process.

TAMSanity and the SPAC Attack

Valuations in the US stock market remain elevated with investors chasing hot stocks with ever greater recklessness. As traditional valuation measures such as price-to-earnings and price-to-book no longer make sense, one must get creative. In the .com bubble the metric of choice was "eyeballs" the number of website visitors a company recorded – the logic being that visitors would convert to customers, revenues and eventually profits. The current preference is for TAM – the **T**otal **A**ddressable **M**arket. All investors have to do to value a company is to estimate the TAM of a business, assume the company will achieve an arbitrary market share and then apply a multiple of price-to-sales (P/S) to this theoretical market "opportunity" (the multiple is usually obtained through a comparison to other equally overpriced stocks). The beauty of the TAM valuation methodology is that as soon as a company announces a product in an adjacent market, the company's TAM expands and with it the company's valuation! If an enterprise database company creates a security product, simply add the TAM for enterprise databases to the TAM for enterprise security software and apply a multiple. Such analysis logically leads us to believe that the most valuable companies in the world will be those operating in space. The ultimate frontier is after all, infinite, hence the company's TAM would be infinite, and it would justify an infinite valuation! This statement, while made tongue-in-cheek, is not as far from current market reality as it might appear. Virgin Galactic Holdings, Inc. (SPCE), the space tourism company with no sales and no successful test flights is being valued at over $14 billion.[15]

Fig. 1: The Technology Sector Now Has ~$1 Trillion of Market Cap with Negative Earnings



Another symptom the of the current mania is the proliferation of SPACs – so called blank check companies – created with the sole purposes of acquiring other companies. We have written about SPACs back in November 2020[16] - but since then the mania has only grown. A typical SPAC will have $10 in cash per share held in trust. Last fall, these stocks would trade at around $10 / share and shoot up to $20+ when they announced a deal. This was seen as easy money – either the company does a deal and you double your money, or the cash is liquidated and returned to investors after the deadline to do the deal expires. But that was last fall. Today many SPACs trade at $14-15 / share with $10 of cash / share. The rewards have decreased while the risks have gone up. Yet a record number of SPACs are coming to the market. Might the competition from SPACs to do deals and the incentives of the SPAC promoters (doing a deal leads to a

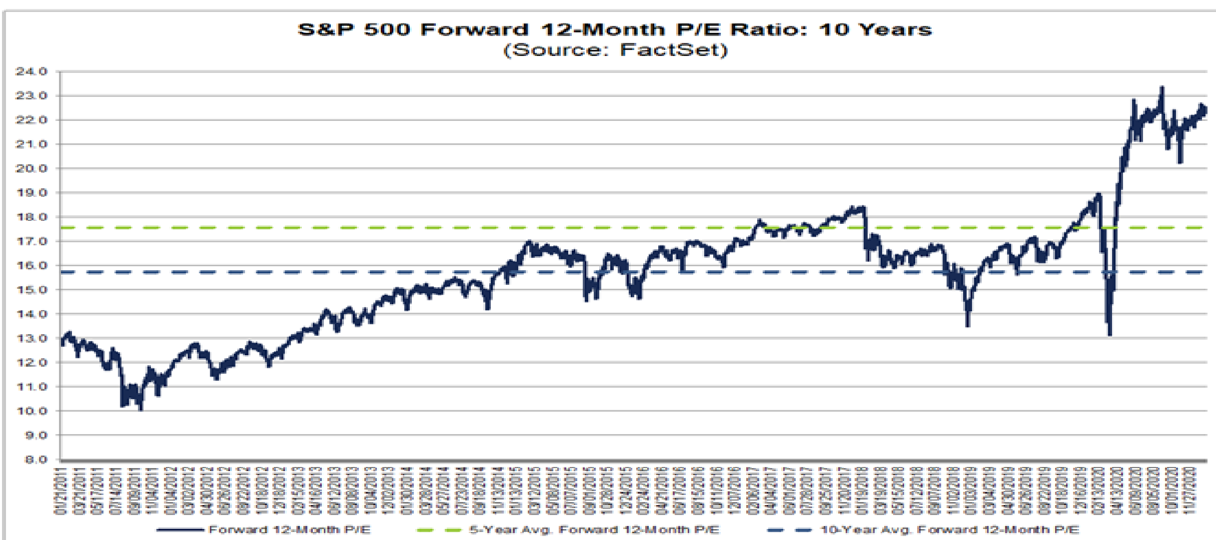
[15] Source: Sentieo.

[16] https://www.lrtcapital.com/wp-content/uploads/2020/12/2020-11-November-Performance-Update-Public.pdf

big payday) influence the quality of the deals being done? After all, there are only so many "great" private companies waiting to be acquired. SPACs are pitched as an easier way for a company to go public. This much is true. But what about the quality of the companies going public in the first place? Recall that Nikola (NKLA), the fraudulent hydrogen truck company, whose chairman resigned in the wake of a sexual allegation scandal[17], became public last year through a SPAC. Just like mortgage securitization was a good idea at first, when more and more money poured into the space, mortgage origination quality declined. This eventually led to the subprime mortgage crisis. Will history repeat itself? How will these SPAC deals perform? Only time will tell.

To give you a sense of the deals being done, consider the recent acquisition of Latch (SPAC symbol TSIA), a maker of smart locks. Latch sells itself as an "Enterprise SaaS Platform LatchOS" with a "entire ecosystem around our full building operating system" – beautiful language for a business that ultimately sells smart locks and the apps needed to operate them. The company is being valued at $1.56 billion on sales of $18 million and losses of $61 million. Latch predicts it will have revenues of $877 million in five years' time. This may in fact happen, but the company is not without competition. Smart locks as a category is full of well capitalized competitors many of whom have decades of experience and established distribution channels. We don't see Latch having any particular advantages in this marketplace. And this is one of the better deals we have seen in recent days. SPAC investors beware!

Fewer and fewer people bother to analyze fundamental information these days. At LRT we increasingly feel like inhabitants of an island with a dying population. Fundamental investment analysis has become a punchline for jokes in fact. The common refrain has become: Do you want to analyze financial statements and accounting policies, or do you want to make money? More and more people are now declaring themselves "make money" investors.



Our Strategy

At LRT, we focus on investing in easy to understand, cash generative businesses. We seek out shares in companies that poses durable competitive advantages, can grow, and reinvest capital at high incremental

[17] https://www.cnn.com/2020/09/29/tech/nikola-trevor-milton-assault-allegations/index.html

rates, and have management teams with a proven record of good capital allocation. The LRT Economic Moat Strategy has outperformed the S&P 500 since the second half of 2020 when we became fully invested. We believe that once we lap March, our one-year trailing returns will look very attractive. You don’t have to chase SPACs or speculative investment to do well in the stock market.

The valuation of the overall market is very high. Historically when valuations are this high, future returns are **negative** for the market overall. We believe that the only sound way of generative **positive** returns going forward is to focus on specific companies with growing profits that trade at reasonable valuations. We believe that the portfolio that we have constructed at LRT meets this test.

We continue to be defensively positioned – our portfolio is concentrated in safe and predictable businesses with growing earnings. In our next letter to you we will review the portfolio and our top positions in more detail.

Thank you for your continued trust and support. If you know someone who may be interested in the fundamental, no nonsense investment approach that we practice at LRT, please send them our way.

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

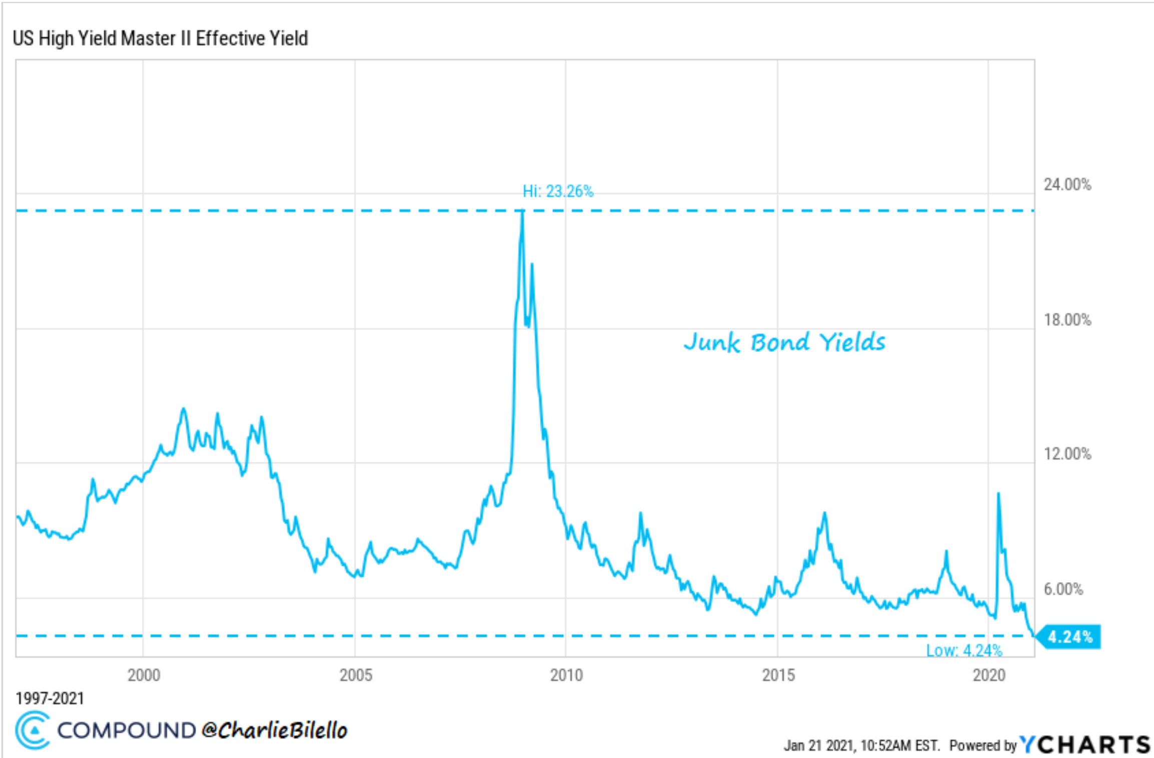
We view stock market volatility as a source of opportunity. Volatility allows us to profit by acquiring shares in superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

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 – Additional Charts



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