January, 2019

Dear partners,

As you know, our general approach to investing involves trying to think in 3 to 5+ year blocks of time. As our third year has drawn to a close, for the first time we can start to take our results somewhat seriously. Since inception, we have returned 60.1% net of all fees, vs. 41.5% for the S&P500, and 42.4% for the R2000.[1] Annualized, we compounded at approximately 17%, versus 12.3% for the SP500 and 12.4% for the R2000. Of course, our 3 year numbers are of little comfort to investors that joined more recently, and for the full year we returned -12.3%, vs. -4.4% for the S&P 500 and -11.0% for the R2000. All of our losses came in the fourth quarter, when we returned -22.3% vs -13.5% for the SP500 and -20.2% for the R2000.

The recent dramatic decline in small cap stocks broadly and in our portfolio specifically is of course unfortunate in the near term, especially for partners (including my wife and I) who contributed capital to the partnership for an October effective date. Tradition dictates that following a period of difficult performance such as this the investment manager lists the ways in which the market unfairly conspired against the portfolio, and explains why it will not happen again. However, as nothing about our partnership is traditional, I am going to take a different tack and simply restate what I have stated one way or another in every letter since inception. Our goal is to maximize long-term creation of wealth, and there is an enormous amount of evidence to suggest that ignoring the stock market while owning a concentrated portfolio of off the beaten path investments is the best way to accomplish this goal. However, long-term outperformance does not come for free, and the price of admission is the willingness to stomach temporary setbacks along the way. This was a difficult period, and we will have more difficult periods in the future. We are also likely to have periods of exceptional performance, and if we can remain patient and simply focus on owning good businesses, led by incentivized managers at cheap prices, over time we will be rewarded. While our portfolio traded down in line with small cap indexes on the year, for the most part, our businesses marched forward. Focusing on our process and the fundamental attributes of our businesses – not the price at which they are bought and sold on a second by second basis – will determine our long-term success.

This approach is not original. But it is uncommon. Rather than attempting to predict the madness of crowds over short periods of time as most market participants do, we are simply following Buffett's advice, and pursuing lumpy outperformance rather than stable mediocrity. As a reminder, over longer periods of time small amounts of outperformance can have large effects on ultimate value due to the magic of compound interest. For example, $1 million invested for 10 years at 6% turns into ~$1.8M, while $1 million invested for 10 years at 9% turns into ~$2.4 million, or 32% more. We are playing for longer than 10 years, and we are not playing for 6-9% returns. As the time line gets longer, and the performance gets better, the numbers get silly: $1 million at 17% for 30 years turns into $111 million. We are a long way from a 30 year track record and the only thing that can be guaranteed in the future is that we will at times have periods of disappointing performance. However, we are off to a good start, and I fully believe that we will also continue to have periods of significant outperformance. For this reason, almost the entirety of my and my family's wealth is invested in our strategy. Our interests are aligned.

[1] LWC began operations on February 8, 2016

Portfolio Review and the Foundation of Intelligent Investing

> "It has never been harder to make money in the short term, and it has never been easier to make money in the long term."
>
> ~Bill Miller

Following a volatile period in the markets, a high-level portfolio review is warranted, as it will aid in our quest to remain rational. As of year end, there were 14 companies in our portfolio of note. Of these 14 companies, 5 of them are judged to be recession proof in that their business should either benefit from recessionary conditions, or in the worst case continue to operate as usual. An additional 2 businesses are judged to be recession resilient by the nature of long-term contracts and secular tailwinds. A 3rd may fall into this category as well, although it is too early to know at this point. Four of our businesses have cyclical characteristics, but in my view are currently priced as if we are in a deep recession, which we are not. Importantly, each of these cyclical businesses has multiple strategic options in front of them, which can drive value regardless of the economy. Further, 2 of them should be able to take market share or otherwise grow during downturns, and 1 of them will have defensive cash flows during any downturn as working capital is released. Five of our businesses are judged to be valued below their breakup value if they were simply shuttered and sold for scrap (which they will not be). Seven of them are judged to be trading at a low to mid-single digit multiple of their earnings, looking out a few years. Eleven of them are at severe discounts to private market value or peer companies. Twelve of them are run by owner operators or have seen insider buying within the last 12 months. All of them have qualitative factors that should drive value over longer periods of time. None of these qualitative factors can be observed by the short-term oriented quant driven investors that dominate the stock market over shorter periods of time.

You will note that there is overlap among these numbers, and they don't all conveniently add up to paint a full picture of the portfolio. Precision is not the point. Rather, the point is that on the whole we own a portfolio of businesses that are attractively priced, led by motivated people, that should perform well over time, regardless of the economic picture. This puts the probability of future success heavily in our favor, even when factoring in that undoubtedly there are mistakes hiding somewhere in our portfolio. Of course, this says nothing about how the stocks will perform over shorter periods of time, as evidenced by our 4th quarter returns.

To illustrate how strangely stocks can act over short periods of time, consider the behavior of a few or our specific stocks in light of recent fundamental developments. First, a private peer of one of our portfolio companies was purchased in the fourth quarter at a multiple that implied 250% upside for our company. Second, in the fourth quarter one of our companies provided new details surrounding ambitious growth plans. This business is counter-cyclical, and grew same store revenues by a cumulative 50% through the Great Recession, so if a recession is indeed on the horizon, this business should do very well. Third, one of our companies moved to finalize the sale of one of its operating businesses, which will remove a large unfunded liability from the balance sheet, as well as add a mountain of cash. This cash will soon be in the hands of an investor who generated 300+% returns following the Great Recession. I would note that if a recession is on the horizon, while the quoted value of this cash will remain the same, the relative value of this cash will soar as the returns it is likely to earn in the future go up.

If we owned these businesses in full in a private structure, we would likely be celebrating as we adjusted their values upwards based on these recent events. Yet in the public markets, each of these companies saw their quoted price decline by between 30-40% over the last 3 months. Of course, price action on its own tells us nothing, because if all of these companies were drastically overvalued at the beginning of the quarter, the dramatic moves downward might be completely justified. However, two of these companies trade below our estimate of what they would be worth if the businesses were just shut down and sold off in pieces, and the other trades at a low single digit multiple of the cash I think the company will generate in a few years, and a dramatic discount to recent transactions. This sort of violent price action in light of positive developments fails to pass the common sense test. If you need further proof, I suggest finding someone who does in fact own a private business. Now tell this person that as more than 90% of the stocks in the Russell 3000 sold off by more than 10% in 2018 and 75% of these stocks sold off by more than 20% in 2018, their business is now likely worth 20% less than it was a year ago. I doubt they will agree with you.

With fundamentally positive developments and cheap prices, it is difficult to understand recent negative price action except to say that human nature ensures that sometimes the stock market gets a little bit crazy. Consider that in early December news outlets reported that the exchanges had to halt futures trading 6 times due to the violence of the swings. As a headline, that sounds like the sky is falling.

Now consider that each of the 6 halts lasted for 10 seconds.

In my mind, that makes zero sense as it relates to the value of businesses... but if we were talking about competing computer algorithms vying for pole position, then the picture begins to become clearer. In fact, according to a recent report by JP Morgan, less than 10% of stock market trading these days is done by fundamental investors, with the bulk being quants, algorithms, and passive strategies that typically rely on pre-defined decision rules and momentum strategies to make buy and sell decisions, without taking into account company specific positive developments that have yet to conveniently appear in GAAP financial statements. For our portfolio, which is mostly made up of smaller companies, these effects are amplified because limited liquidity means that one panicked seller can push shares down quite a bit.

In brief, the biggest problem that our stocks faced in the fourth quarter is that no one wanted to buy them, while some owners felt the need to sell them. To be clear, we should not completely ignore the macro environment; rising interest rates and uncertainty around trade policy may have unforeseen consequences for businesses and valuations. If we owned businesses that were operating at peak efficiency and selling at lofty multiples, I would be concerned. However, as a reminder, for the most part our companies are presently dealing with some sort of temporary problem. This is precisely why we own them. We shouldn't care if no one wanted to buy them during the quarter, because we don't want to sell them until they move past their temporary problems, and are realizing their true potential.

The greatest advantage an investor can have is patience, and the market frequently discards businesses that are not presently operating at their full potential, often preferring expensive stability to bargain uncertainty. This is especially true with smaller stocks. For our portfolio, on a multiyear time line our results will be most heavily influenced by the ability of our businesses and our management partners to navigate the problems in front of them. If they are successful, the stocks will perform well, regardless of what else is happening in the world.

To be clear, I don't want to be dismissive of our recent performance. There are always things that I could have done better, and lessons to be learned, and if my attitude seems cavalier, I assure you there is a measure of false bravado at work. I am certain that my friends and family group makes up the largest cohort of our investor base, and personally I would be shocked if any of our partners had a larger amount of their investable net worth invested in the partnership than I do, so to the extent that I feel our recent drawdown at all, I feel it more than anyone else. I have however become rather adept at ignoring the volatility, which history has proven is the surest path to long term compounding of wealth.

There is an enormous amount of evidence to suggest that how one behaves during difficult periods is a major determinant of long-term investing success. Thus, during periods of difficult performance, it is vital to remind ourselves that the foundation of intelligent stock market investing is recognizing that owning a stock is owning a piece of a business, not a piece of a paper that goes up in down in value all day. Over short periods of time the price of our stocks is set by the weakest hand, but over longer periods of time, the value of our businesses will be determined by their ability to perform. Despite recent price weakness, our businesses continue to execute against their plans, ensuring that their value will increase with time. Eventually, the market will get it right and reward our patience. The key is making it to "eventually." The fact that our partnership is comprised fully of individuals with patient capital and a deep understanding of the difference between price and value is an invaluable competitive advantage in this pursuit, for which we should all be thankful.

Top 5 Holdings

EZCorp (EZPW) – EZPW should be familiar as we have owned the company for 3 years now. Operationally, the company performed exceptionally well in 2018, yet shares traded down ~35% on the year. When a top position trades down 35%, it is going to put a dent in our performance. I presented EZPW at the Best Ideas Conference, hosted by the Manual of Ideas, in early January, and I have attached the slide deck to this email. The short version is that EZPW is a cash flowing, growing, recession proof business that is trading well below my estimate of net asset value. To be clear, there are things not to like here; most notably a controlling shareholder that has not always looked after the interests of minority shareholders. However, recent changes to corporate governance are a step in the right direction, a series of one-time events will roll off in 2019, management has announced a clear plan for continued growth and operational improvement, and with time I believe investors will realize that a much-hated convertible bond offering completed in May of 2018 was done for the right reasons, at attractive prices. Importantly, potential dilution tied to this convert will not kick in unless shares rally by ~100%. It is also worth noting that this is a business whose already bright prospects should accelerate if a recession is on the horizon. I added to our position near the 4th quarter lows, but I also added as the company first traded down toward my estimate of net asset value per share. These purchases are significantly under water. While in general asset value is a useful road sign for downside protection, in the case of EZPW where market participants are concerned about potential dilution, I should have built in an additional margin of safety beyond asset value. This was a mistake.

Fiat Chrysler (FCAU) – Fiat is somewhat unique amongst our names in its cyclicality: if there is a recession, this business will suffer. However, given the strength of the company's brands and the strategic options it has in front of it, at these prices in my view it is worth looking through any potential slowdown in business. Fiat has proven that they are willing and able to pull multiple levers to create value, most recently with the sale of their parts business, which will close shortly. They have also indicated that a potential sale of their robotics business may be in the works, and they will be establishing a financing business in the U.S., which is a much better business than selling cars. They are also entering new verticals with the Jeep Gladiator and 3 row SUVs, which should provide a measure of growth even if the macro environment softens. Additionally, I believe that at some point the entire industry will re-rate higher.

If there are two businesses, both of which are cyclical, but one of which loses money during a recession, while the other is able to break even, all else equal the one that breaks even deserves a higher multiple. This is easy to see when thinking about two businesses in the same time period, yet remains true if we are thinking about one business in two different time periods. Simply stated, auto OEMs are much better businesses now than they were prior to the financial crisis because they have shifted their business models and reshaped their liabilities in such a way that they should be able to break even in all but the most severe recessions, and as such, they deserve higher multiples than they used to.

Long range forecasts should of course be viewed skeptically, but FCAU believes they can earn somewhere around $7 to $8 per share in 2022, meaning that we are presently paying a future P/E of 2 for a company with very strong brands, multiple strategic levers available, an incentivized controlling shareholder, and the pending launch of a recession resilient financing business. We may need to weather a recessionary period to prove out my belief that the sector will rerate higher, but as success would lead to multiples of the current price, the odds are heavily skewed in our favor.

Hill International (HIL) – HIL is an asset light construction management company that I detailed in our Q3 letter as a special situation. We were able to buy our shares in HIL at a price that implied we were paying a reasonable price for the U.S. assets, and getting all of the company's international assets for free. This bargain price came about because a financial restatement tied to currency translation had caused the company to be de-listed from the NYSE, which forced its many index related holders to sell their shares regardless of price. I sized the position larger than I normally would have based on an imminent re-listing, believing that anyone who wanted to or needed to sell had sold during the de-listing process. I reasoned that with all of the sellers out of the way, there would be only one way for the stock to go.

This initial upsizing was a mistake, and Hill traded down ~30% following its re-listing. Again, when a large position is down 30%, it hurts.

While admittedly the company's first conference call following the re-listing was a missed opportunity to reset the stage for HIL, I was baffled by this price action until mid-December when an SEC filing revealed that one of the company's largest holders had been selling shares. I have since heard it whispered that this fund was facing redemptions, and was thus a forced seller in their own right, and I am all but certain that tax loss sellers joined the fray into year end. These are non-economic factors, and this is a recession resilient business due to its long-term contracts. With multiple strategic options in front of the company including selling under-scaled international operations and leveraging their domestic operating structure through M&A, not to mention realizing the benefits of a ~$40M cost saving initiative, I remain confident in HIL's future and have added to our position. This confidence is apparently shared by insiders, as there has been a flood of buying from members of the company's board of directors and management team.

I would also note that while a sale of the company is not necessary for success, several of HIL's largest shareholders have called for a sale in the past. M&A has been rampant in the space, and reviewing the public documents attached to other recent transactions reveal 10+ potential buyers of the company. Under the heading of “reading tea leaves” consider the following sequence of events:

- November 2014 – Craig Martin retires as CEO of Jacobs Engineering (JEC)
- February 2016 – Craig Martin joins the board of Hill
- May 2017 – Craig Martin becomes Executive Chairman of Hill after activists remove David Richter as CEO. Richter says that Hill should sell the company, and JEC would be a logical buyer
- October 18, 2018 – Craig Martin resigns from Hill’s board
- October 21, 2018 – JEC announces the sale of their Energy, Chemicals and Resources business, and lists a renewed focus on their Infrastructure and Government Services business (HIL’s area of expertise), including M&A as a use of proceeds

I have no idea if JEC is going to try to buy Hill, but if they are, Martin’s resignation as Executive Chair would certainly remove any potential conflicts of interest.

Iteris (ITI) – Iteris is our traffic management business. We have owned the stock for 3 years now, and it has been a bumpy ride. We ended the year with a ~75% gain since initiation, but the stock was down nearly 50% on the year. Most of the damage was done in Q1, and I detailed the temporary problems that the company is facing in our Q1’18 letter. The most notable issue that the stock has faced is that the largest shareholder died, and his estate has been selling shares. This is of course frustrating, but it clearly has no effect on the quality of the business.

Simply stated, when a top 5 position is down 50%, it is going to put a dent in the portfolio. However, while the stock traded down substantially, my view of the intrinsic value of the core transportation businesses has increased, and while this downdraft is a drag on our results in the near term, I have added significantly to the position. It is difficult to put this business into a box as it has elements similar to consulting, government business process outsourcing, and asset light project management, but each of these types of businesses typically trade at high teens to lows 20s cash flow multiples. However, cash flow here is temporarily obscured as management has made the difficult decision to invest for the future, which should be bright. The company is now at a point where their existing operating structure can be leveraged through future growth, and the rolling off of the one-time items that the company faced in 2018 combined with the increasingly software centric nature of the business should set the stage for a rebound in the stock in 2019 and beyond.

Additionally, recent transactions among peer companies suggest that Iteris is worth multiples of its current price as the strategic value of intelligent traffic systems becomes apparent in the context of the future of smart cities. Lastly, Iteris is still investing in a venture stage agriculture business (“Ag”) that obscures the value of the traffic business in the GAAP financials. If management is able to execute on their plans for Ag, this business alone could be worth more than the current market cap looking out a few years.

Radisson Hospitality AB (CPH:RADH) – Radisson was introduced in the Q3’18 letter as a special situation. Essentially, due to a wrinkle in Swedish takeover law and some game theorizing of the likely behavior of Chinese state-owned conglomerates we were able to be temporary owners of a European hotel chain with negligible downside, and the potential for significant upside. Last week the Chinese conglomerate submitted a bid of SEK $42.50 per share to minority holders, versus the mandatory minimum bid of SEK $35. I think this bid undervalues the assets, but I am not interested in owning a cyclical hotel turn around for the long term, and am thus happy to take a quick ~20% return.

Comments on Select Investments

Gaia Inc. (GAIA) – GAIA is a niche streaming video business focused on yoga and other alternative content that we have owned in varying sizes since late 2016. Shares reached a high of $22+ earlier this year, and then sold off by more than 50% into year end. The company has been hitting or exceeding all of its operational and growth goals, and believes they are on track for $2.50 in EPS for 2021, but it is of course impossible to know with any certainty if they will reach this goal. The most widely tracked metrics to judge the company's intermediate success is customer acquisition cost (CAC) as it relates to life time value of a customer (LTV), and of course the cash on the company's balance sheet as GAIA is sacrificing current profitability in pursuit of growth. CAC is not disclosed in any detail, but can be imputed from the financial statements. The selloff began as analysts took a "shoot first, aim later" approach to rising CAC. In my view, recently elevated CAC is tied to several factors that are transitory, or will meaningfully drive additional revenue. Most notably the company is building an event space that will drive high incremental margin revenue, and completing language translation which will open up new geographies for the company. Additionally, the company is investing to move beyond its core "Seeking Truth" niche and into Alternative Healing. It seems odd to me that bears who once criticized the Seeking Truth niche as too small or too weird are now criticizing the move into a niche that is more mainstream and likely larger.

In any case, after hinting at the possibility on their last conference call, management has recently increased the subscription price by 20%, and in this business, incremental revenue is almost pure margin, which should raise LTV, and lengthen the runway for the company to grow into its operating structure. Importantly, the company could be profitable at any time with 30 days notice by simply slowing their aggressive growth spending, but the owner operator founder/CEO is confident in success, and would rather focus on the big picture than current profitability. It is also worth noting that anecdotally, yoga participation rose straight through the financial crisis. Additionally, it is well known that during recessionary periods participation in activities that provide comfort to people goes up, with the obvious example being church attendance. I can't claim to understand the allure that GAIA's customers find in their Seeking Truth content, but it seems at least possible that this content will be recession resistant. At the very least, while this business is untested through a recession, I believe it is likely more recession resilient than many would expect.

To be clear, the future is less certain here than most of our investments because we are treading in unchartered territory. However, the odds are strongly skewed in our favor as success likely means 500-700% upside from current prices, and downside is capped at some level by the value of the company's real estate and IP.

Ocwen Financial (OCN) – Ocwen was first detailed in our Q1'18 letter. What had looked like a great entry point and was a big winner did a complete 180 in the last 2 months of the year and turned into a mark to market loser. Ocwen is in the mortgage servicing business, and the headline problem here is that higher interest rates mean higher mortgage rates, and higher mortgage rates means lower mortgage applications, which is bad for mortgage servicers because they must consistently add mortgages to their portfolio to replace those that roll off as people pay off their mortgages. Historically and generally the correlation has been valid, but a trip into the world of common sense shows that it does not fit for Ocwen today. For regulatory reasons Ocwen has been prohibited from participating in the purchase of bulk mortgage servicing rights (MSRs) for the last several years. However, that changed just a few months ago, and when Ocwen completes a transfer of their MSRs to a new servicing platform (expected in the next 2 or 3 quarters) Ocwen will once again be able to purchase bulk MSRs. The question is thus, “is it better to not participate in a strong mortgage market, or to participate in a weaker mortgage market?” The answer should be obvious to those capable of patiently making this distinction, but patience is in short supply on Wall Street, and with a shareholder base that leans heavily toward quantitative investing, this qualitative distinction cannot be made at all.

The problem was made worse by the fact that Leon Cooperman, OCN’s largest shareholder, announced that he would be shuttering his Omega Advisors hedge fund and returning capital at year end. For those that took the time to read past the headline, it was clear that the vast majority of Cooperman’s OCN holding would survive in other entities, but when a filing announcing that Omega’s international fund had sold shares hit, OCN shares fell off a cliff, perhaps anticipating that the entire ownership stake would be hitting the market.

To be clear, Ocwen’s return to growth is taking longer than I had originally estimated, which does reduce my estimate of intrinsic value by a touch. Additionally, in retrospect, I should have been more attuned to the above-mentioned trading factors that caused OCN shares to fall by ~66% in the quarter, and reduced our position as its size grew through rapid appreciation following our initial purchases. In general, I believe that ignoring trading noise is a better strategy for long term compounding of wealth than trying to anticipate the short-term movements of the market, but in this instance, it had been obvious for several months that the combination of the quant focused shareholder base and Cooperman’s pending sales had the potential to drive a large move down in the stock, yet I did nothing. My inactivity was because even at the highs OCN traded well below its tangible book value, and when the technology transfer is complete in a few months, OCN will be able to flex its operating structure, which should lead to shares trading at tangible book if not higher. Ordinarily focusing on balance sheet strength provides downside protection, but in the case of Ocwen, a fair amount of this tangible book value is non-GAAP, meaning that the quant investors focused on mortgage rates are not aware of this additional balance sheet strength. Longer term I think we will be proven right, and shares have already rallied by 50% from their lows.

New Investments

Recent volatility has revealed many opportunities. It is a bit like drinking from a fire hose at the moment, and we have established a few new small positions that may grow larger in the weeks and months to come. As we are still in the process of buying these stocks, I will refrain from discussing them for now. I look forward to sharing more information in the months to come.

Short Investments

The best investments are those where potential downside is limited and well defined, while potential returns are substantial. Single name shorts rarely fit the bill because by definition you are fighting against a business that is trying to improve, and downside can materialize instantly in the form of a sale of the company. However, in my view being short high yield ETFs is a lopsided proposition, and we established a position some months ago.

With rates near record lows, spreads near record tights, and defaults near record lows, it was and is difficult to see how we could lose money other than our cost of carry. The obvious answer would be if rates go lower, bond prices should move higher, but in my view, the only way that rates will move substantially lower is if the Fed were to cut rates in response to a weakening macro environment. If the macro environment weakened to the point of a rate cut, I would expect that spreads would blow out, defaults would tick up, and high yield would trade down more in line with equities rather than up with more defensive bonds.

For high yield ETFs, the effect should be compounded by the shortcomings of the ETF structure. Unlike their equity brethren, bond ETFs do not have a well-defined index to mimic, and are thus reliant on human decision making. If (when) high yield begins to roll over and redemptions move higher, the ETF's portfolio manager will be forced to sell what he or she *can* sell, not what he or she *wants* to sell in order to meet those redemption requests. Unfortunately for the portfolio manager, the best credits with the shortest durations will be the most marketable, which will have the effect of forcing the portfolio manager to sell the strongest pieces of their portfolio, leaving them with an even less attractive portfolio, which will only make their problem worse.

To date this short position has not protected our portfolio in any meaningful way, as the high yield market has mostly shaken off recent concerns of economic weakness, unlike the stock market. However, the situation remains highly asymmetric, and you never need insurance until you are glad you have it. As such we continue to hold a short position in HY credit ETFs.

Addition of New Partners

In our last letter I indicated that we would be temporarily closing our partnership to new partners absent a notable pullback. As that pullback has arrived, **we are once again accepting new partners**. If you are aware of accredited individuals that are capable of stepping away from the crowd and thinking independently in the pursuit of market beating returns over the long term, please refer them to the "letters" section of www.laughingwatercapital.com. Reading the materials posted there will give them an idea of what we do, why we do it, and how we are attempting to build a competitively advantaged investment partnership.

K-1s and Upcoming Events

I have been in touch with Spicer Jeffries regarding our 2018 audit and tax preparation. They assure me that everything is on schedule, and K1s should be available for limited partners before March. If you have any questions, please let me know.

I will be travelling to Omaha for this year's Berkshire Hathaway meeting, so if you will be in the area and would like to find time to meet, please let me know.

Details have not been finalized, but I will be organizing a Laughing Water Capital partner's meeting later this year, likely in September or October in Manhattan. Please stay tuned for details.

Looking Forward

As always, I have no idea what the market will do in the near term, and I suggest that you regard anyone who tells you that they do as a liar or a fool. What is clear is that at the moment macro concerns weigh heavily in the minds of investors. It is certainly possible that the market will trade lower in the months that come, and that our portfolio will follow suit.

This is always the case.

It is also possible that macro concerns will quickly fade. It seems as if the Fed has already started to back off from an initial hard line regarding rising rates and quantitative tightening. Additionally, in my view, the trade war with China in particular seems vulnerable to a quick resolution, as it seems obvious that our President cares about the stock market, and is likely aware that historically incumbents have had difficulty being reelected when the stock market has been weak. It is not difficult to imagine a way for Trump to declare success, even if not much really changes, in which case stocks would likely quickly move higher.

Regardless, what is absolutely clear is that historically, trying to predict macro events has been a losing proposition. As such, in my view the key to long term success is not to worry about market bottoms and price action, but rather to get comfortable with the idea of "cheap enough" when making investments. Personally, my family added to our investment 3 months ago, near our partnership's highs for the year because I thought that our portfolio was cheap enough to generate returns looking forward a few years that were sufficiently attractive. Today, while the market and our portfolio has gone down, the potential for future returns has gone up, and we are adding to our investment. In my view the potential returns are sufficiently attractive that if they become even more attractive next month, I will not be disappointed.

As always, for the most part, our future success will be based on our ability to identify businesses that will be substantially stronger in 3 to 5 years than they are today. Our returns will be enhanced by the assumption that at some point in the next 3 to 5 years, the market will put a "normal" multiple on those businesses, as opposed to the discounted multiples that they carry now. Nothing that has happened to the stock market in recent weeks has changed this, and given the broad nature of the selling, there are many exciting opportunities to investigate at the moment. I will continue to iterate our process, and follow our common sense strategy of buying good businesses, led by incentivized managers, when they are available at cheap prices. To paraphrase investing legend Seth Klarman, when buying good companies led by incentivized managers, taking advantage of discounts requires action on the way down when sellers are plentiful, not on the way up when sellers are scarce. Our returns will not come in a straight line, but with time I am confident we will be rewarded.

Matt Sweeney, CFA

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