

April, 2020

Dear partners,

First, I hope that you and your families are all healthy and taking every necessary precaution during this uncertain time. For the first quarter our portfolio declined by -20.0%, versus -20.0% for the SP500, and -30.6% for the Russell 2000. In every letter I caution that our performance vs. the indexes over shorter periods of time is meaningless, and that is especially true now as there have been many instances of stock prices moving by 20, 30, 40, or 50% over the course of days, if not hours. I point this out to emphasize that in the real world, assuming a strong balance sheet and reasonable competitive position, the value of a business simply does not move so violently over such a short period of time.

Our portfolio performance belies the performance of many of our underlying stocks, many of which are illiquid, and thus easily punished by the market during times of panic when stock prices are more a function of supply and demand than business fundamentals. There is an abundance of evidence that suggests accepting near term illiquidity and volatility is the cost of admission to enjoy long term outperformance. In my view, the quoted prices of many of our businesses say more about the liquidity needs and inability to control emotion of their former owners than the value of the business.

While thus far the price action does not reflect it, and while there are exceptions, for the most part our portfolio is filled with businesses that can thrive during periods of uncertainty due to some combination of recession resilient revenues and a strong balance sheet. The question thus becomes is this sell off in our stocks rational and appropriate? Or is it more an expression of panic, where market participants are willing to sell anything at any price in order to avoid the unpleasant feeling of seeing the asset quoted later at a still lower price?

The answer is impossible to know with 100% certainty, but we deal in the world of probabilities, not certainties, and in my view it is probable our portfolio has been punished by panic more than anything else. Consider the following:

- If a company is essentially a box of cash, plus a ~50% ownership stake in a business where cash inflows typically don't slow all that much during downturns, but cash outflows typically slow dramatically, why should the stock trade at a market cap that is a fraction of the company's cash?
- If a company is in the business of selling a recession proof essential service online, and their main competitors rely on personal interaction, why should the stock of the online business get cut in half at a time when face to face interaction has all but stopped?
- If a company is in the business of manufacturing recession proof goods from domestic locations, and pundits are calling for the re-shoring of similar goods due to potential shortages during a pandemic, why should the stock of the domestic businesses get cut in half?

If these businesses were trading at high valuations prior to the recent virus induced sell off, perhaps the declines would be justified. However, in my view, these businesses have gone from cheap to very cheap, while at the same time their future prospects have likely improved. At some point, the wave of fear that drove the decline in their stock price will pass, and the market will realize that their prospects have likely improved rather than declined, and reward us handsomely. These are but a few examples from our portfolio, and there are many many more examples in the broader stock market that represent the

potential for fantastic returns looking out to a more normalized time. The important thing right now is to think rationally, and not rely on the minute to minute quotations of the stock market to provide guidance.

To be clear, I cannot claim that the recent selloff won't get worse before it gets better, and I cannot claim that right now is the "best" time to invest. I can state however that given a reasonable time frame, this is likely a very good time to invest, and I can confidently opine that rationality will return to markets eventually, and when it does our portfolio should be rewarded handsomely. I can also say that when rationality returns, investors who bought more at the height of uncertainty won't remember if stocks went down a bit more before they rocketed higher. However, those that stay on the sidelines and miss the opportunity will likely regret it.

Afterall, "The time to buy stocks is when ~~there is blood in the streets~~" other people are buying toilet paper. For this reason, the vast majority of my family's wealth remains invested in our strategy, and we intend to continue adding to our investment in the near future.

## Balance Sheets, "Enough," and Forrest Gump

At a time when much of the investing world is in a panic, there are three main frameworks that I am leaning on to remain rational, and best position our portfolio for the future.

The first should be obvious. At present, when much of the economy is completely shut down, balance sheets take precedence over income statements. While I always focus on owning businesses that can survive or even thrive during a weak economy and thus generally eschew leverage, I admit I had not considered the possibility of revenues at any of our businesses temporarily going to zero. The market has been swift to punish companies with leverage, but it is also a fact that the more predictable a business is, the better it is, and the more debt it can handle. There are many instances of excellent businesses with dominant competitive positions that have been sold indiscriminately because of financial leverage. Some of these businesses face existential risk. However, there are some babies in the bath water right now whose debt has been termed out appropriately, and in some cases these businesses are trading hands at low single digit multiples of normalized earnings. It is important to note that when considering purchasing stakes in businesses such as these we will not be able to pick the bottom. It is entirely possible – perhaps even likely – that businesses which are bought at 3x midcycle earnings can subsequently trade at 2x midcycle earnings, representing a 33% mark to market loss. However, eventually these businesses will trade at a normal multiple of normal earnings, representing potential multi-bagger returns.

The second concept can be best illustrated by Tom Hanks' portrayal of Forrest Gump, who made his fortune by catching shrimp:

"Speaking with local officials, this reporter has learned in fact only one shrimping boat actually survived the storm." - reporter

"after that, shrimpin' was easy." - Forrest Grump

A fictional simpleton with no experience catching shrimp became wealthy by taking market share during a difficult time. As discussed above, it is not possible to pick a bottom in turbulent markets. However, we can pick businesses that can improve themselves in a downturn. Almost all businesses are feeling pain in

the current environment, but by focusing on strong balance sheets, strong competitive positions, and properly incentivized management teams, we are focusing on businesses that are likely feeling less pain than their competitors, meaning that our businesses can take market share or otherwise improve their position vis a vis their competitors during this downturn. When the environment inevitably turns for the better, in many cases our businesses will exit the downturn stronger than they went in.

The last concept is the idea of getting to “enough” when considering potential future returns. Human beings are hardwired to place more weight on near term events than long term outcomes. If our paleolithic ancestors did not place more weight on meeting their immediate needs such as food, water, and shelter, then any long-term plans would be completely useless. In moments of panic human DNA ensures that stocks are often sold with no regard to underlying business value simply due to fear that if a sale is not made now, a still lower price might need to be accepted later.

We are fortunate in that our partnership has been designed to avoid finding ourselves in this situation. We don't use portfolio leverage, and our partners have made long term commitments to our strategy. Thus, while others find themselves panic selling, we have the luxury of deciding when to buy. The question is, how cheap is cheap enough? As mentioned above, a stock bought at a 3x multiple can easily go to a 2x multiple, resulting in buyer's remorse. At the same time, the market is forward looking, and will begin to price in a brighter future before the dawn sunlight edges over the horizon. In other words, those investors who are waiting for the all clear before pulling the trigger are likely to be disappointed: bottoms cannot effectively be picked. For example, during the financial crisis, credit card delinquencies did not peak until 6-8 months after the March 2009 low. By the time the worst of the data presented itself, credit card stocks had rallied 300-400%. There is no catch all answer to the question of when is something cheap enough to purchase, but history has shown that attempting to hold out for the last nickel is likely to lead to regret.

In sum, the depth and duration of the current downturn are unknown and unknowable. However, by focusing on strong balance sheets and businesses that can take advantage of difficult times, our portfolio is well positioned for the future.

## Portfolio Activity

On March 11<sup>th</sup> you should have received an update detailing our 10 largest positions, and referencing hedges that I put in place during the early days of the virus scare. I have attached a copy of that letter to this email as well. As you may have noticed, many of our stocks that suffer from illiquid trading have fallen far in excess of the broader markets, but the hedges have allowed us to keep pace with the large cap indexes. Since that time, I have reduced – but not completely eliminated - our hedges, and I believe that our positioning is significantly better now than it was at the time of the update. It would be a gross oversimplification to note that for most of our *stocks* a simple return to prior still undervalued levels would result in fantastic investment returns. Yet, as many of our *businesses* are primed to excel during uncertain periods, this framework should not be discarded entirely. Further, I have taken steps to add to those businesses with better prospects, while reducing position size in those that are weaker. Lastly, I have added four new businesses that are likely to be disproportionately negatively affected by the virus in the near term. Near term fear drove the stocks of these businesses to levels where I believe returns of several hundred percent are possible in the years to come. All of these businesses have absolutely dominant competitive positions that are likely to improve during this uncertain period, supremely aligned insiders,

histories of excellent capital allocation (especially during business downturns) and balance sheets that will survive temporary business disruption. I am hopeful that I will be able to increase the size of these investments at similarly attractive prices in the weeks and months to come, and thus will not disclose them at this time.

## Looking Ahead

The last month has seen the fastest bear market ever and the fastest bull market recovery ever. It is impossible to know with certainty what will happen next, or with what speed. It does seem likely though that in many cases the severity of recent stock market moves is tied much more to some combination of emotion and algorithmic trading than any staid analysis of business fundamentals. We must acknowledge however that staid analysis of business fundamentals is not possible with any precision at a time when the economy is effectively in depression mode, and the end date of corona virus impact is unknowable. I would also be remiss if I did not note that historically bear markets have been pocked with bull rallies, and it is possible that the recent low was not the ultimate low.

In any case, it seems likely that volatility will persist for some time. I am personally of the view that at present we are enduring depression type conditions, but as a country we will bounce back fairly quickly as the fog begins to clear. There is massive stimulus in the pipe, and there are signs of corporations taking steps that appear to be driven by morality, such as banks and credit card companies agreeing to waive fees and allow for deferred payments. There is also evidence to suggest that bear markets caused by identifiable seemingly random events tend toward the shorter side. However, there is no reason to believe that my vague optimism will prove prescient. It is impossible to rule out the possibility that the current upheaval will bleed into more of a leverage/financial crisis rather than a social/medical crisis, and it seems unlikely that any bounce will return us all the way to prior levels of unemployment and economic activity in the immediate term, meaning normal recessionary conditions may linger. Regardless of the event path, the prescription for our portfolio is the same. I will not be swinging for the fences on some sort of directional bet (bullish or bearish), and I will focus on owning good businesses with capable and aligned management teams that can operate effectively and efficiently during difficult periods while improving their longer term competitive positions. I will also attempt to take advantage of volatility as much as possible to continuously upgrade the quality of our businesses and management partners so that when we reach the other side of the current uncertainty we will own a portfolio of better businesses with better prospects than we do now.

To be clear, it can get worse before it gets better, but I believe we are past the point of “enough” such that we will be pleased by our potential future returns, even if we endure detours along the way. Many stocks are priced as if they are going out of business, and some of them will. But some of them will continue to thrive even in extended recessionary scenarios. I encourage you to consider taking advantage of the recent opportunity, and note that many of our management partners have recently been purchasing stock in their own companies. They are no more capable of picking a bottom than anyone else, and it is possible that a month or three from now they will wish they had delayed their purchase decisions. However, the odds are good that a year or three from now they will be happy that they bought when they did.



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Please let me know if you have any questions, and if you plan on adding funds at this time, please let me know as soon as possible. Funds must be wired by April 1<sup>st</sup>, and I have attached the necessary paperwork which details wire instructions to this email.

Good health to you and your families,

A handwritten signature in black ink, appearing to read "Matt S", with a large, sweeping flourish at the end.

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Note: An earlier version of this letter was sent to limited partners with preliminary results prior to quarter end, and minor edits have been made to this updated version.