

January, 2021

Dear partners,

Laughing Water Capital (“LWC”) returned 28.2% in the 4th quarter after all fees and expenses, bringing our full year net return to 67.9%. As always, individual results may vary, so please reference your personal statement. By way of comparison, the SP500TR and R2000TR returned 12.2% and 31.4% respectively for the quarter, and 18.2% and 19.9% respectively for the full year. I remind you that comparisons to the indexes are only useful over extended periods of time. Simply stated, we do not own the indexes, so there is no reason to expect our results to track the indexes in the near term. At times we will outperform, and at times we will underperform.

As we ended the year only a few weeks shy of LWC’s 5 year anniversary, we can confirm the preceding statement with data. LWC’s operations have now spanned 20 quarters, and of those 20 quarters we outperformed the SP500TR 11 times, and the R2000 10 times, meaning that over 3 month periods, our relative performance is essentially a coin flip. However, in the ~5 years since inception, LWC has compounded at 27.1% net per year, vs 17.5% for the SP500TR and 16.8% for the R2000.

In my view, five years is enough time to warrant a moment spent appreciating our more than 1,000 bps a year outperformance vs. our most relevant benchmark: but only a moment.

The moment has passed.

The market doesn’t care about the past 5 years, and our successes and failures over the next 5 years will be entirely independent of the past. Further, we will be best served by acknowledging that while our relative performance stands alone, our absolute performance undoubtedly benefitted from a positive environment. It would be in our best interest to remember that on 2 separate occasions over the last 5 years the small cap indexes saw declines of 20% or more. I have no idea when, but history has shown that at some point we will see large market drawdowns like this again, and it is unlikely that our portfolio will be immune. Additionally, it is possible that we will see large drawdowns in our portfolio that are unrelated to the market, but rather due to mistakes of commission by yours truly.

Yet, I remain confident in our future due to the elegant simplicity of our process. As a reminder, we are often buying businesses that are dealing with some sort of operational, optical, or structural problem that we believe our management partners can move past in the not-too-distant future. As the problem is overcome, our stocks should benefit from both improved fundamentals and improved market sentiment. This is a very different recipe than the blue sky, infinite TAM, growth at any price strategies that have been dominating the market in recent years, and in my view it is more sustainable.

This is because the key ingredients upon which we rely are timeless. Remain patient. Be conservative. Separate risk from uncertainty. Understand incentives. Exploit the shortcomings of human nature and market structure. These simple elements do not demand a favorable backdrop to ensure long term success, and they are not reliant on herculean assumptions regarding competitive dynamics and growth rates. Rather, they are tied to common sense, and if I can continue to execute our process, I believe we will be pleased with the long-term results. For this reason, almost the entirety of my and my family’s wealth remains invested in our strategy.

A Sincere Thank You

Five years ago when Laughing Water Capital launched, I was already 4 years into my decision to sabotage a lucrative Wall Street job in order to pursue my passion of investing. I was thus significantly underwater on my decision, and all I had was a supportive wife, a new baby, a spare bedroom, and a determination to build an investment partnership with every conceivable competitive advantage in mind. Specifically, this meant choosing to stay small, and choosing to severely restrict my ability to attract AUM by only accepting capital from limited partners who were willing to commit to a long-term strategy.

Five years later, all of the pieces are still in place, including another new baby due any day now. The only real change is that working from a spare bedroom is no longer considered to be amateurish, and while still small, our increased scale removes any doubt related to the long-term viability of the business.

I owe a sincere thank you to all of you who put your faith in me before LWC had a reasonable track record to demonstrate that my unconventional approach to investing could lead to unconventional returns. I also owe a renewed promise to each of you to remain true to the foundational elements of our success: small size and patient capital. We will have our ups and downs along the way and nothing is guaranteed, but I remain convinced that a partnership such as ours is well positioned for continued outperformance over the decades to come.

A Tale of Two.... Everything...

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair[.]

~ Charles Dickens, *A Tale of Two Cities*

The purpose of these letters is to keep LPs informed of what we own, why we own it, and how I am thinking about the portfolio and the world. I don't intend to torture historical or literary references in an attempt at (faux) sophistication, but I just couldn't resist with the above quote because it so perfectly captures the world we are in, and the market we are in.

The market has raced to all-time highs, but the state of the real economy remains an open question.

There are definite pockets of excess in the investing world, yet in my view there are still incredible bargains available.

The Fed is pumping a massive amount of liquidity into the world, and we will only discover the unintended consequences well after the fact.

For several years mega cap growth stocks have dominated the indexes, but in recent months the pendulum has swung to small cap value stocks.

In a world where recency bias will ensure that the next pandemic will surely be on everyone's mind, every business in the world needs to re-shore supply chains, bulk up inventory, and fortify

their balance sheet, all of which would weigh on margins and ROA. Yet, companies are running lean as COVID has made aggressive expense management the norm. Pent-up demand thus represents tremendous torque in the system as any increase in revenues sparked by a return to normal combined with lean cost structures means operating leverage, and large increases in earnings.

What does it all mean for us? In the famous words of super-investor Joel Greenblatt, “I don’t know and I don’t care.”

I could spend pages pontificating on why the aforementioned pent-up demand and torque will lead us to a “roaring 20s” period, and how the rotation to small cap value should benefit our portfolio. However, as even the “experts” are wrong about these sort of macro calls with alarming frequency, that would mostly be a waste of time.

The reality is that over reasonable periods of time whatever tailwinds, headwinds, or crosswinds the market provides will be reduced to noise. Rather, what will matter is whether or not we are able to pay reasonable prices today for businesses whose earnings power will be higher in 3-5 years. On this front, I remain as confident as ever in our portfolio’s prospects.

In order to stay true to this goal, we will do what we always do: focus on good businesses, led by properly incentivized people, that have the ability to improve themselves through difficult periods, while they are dealing with some sort of optical, operational, or structural problem that I believe can be solved over a reasonable period of time. Human nature ensures that the market will continue to act as if “the worst of times” brought on by temporary problems will never end, and we will continue to seek out situations where thoughtful analysis suggests that the “season of light” is only a year or three away.

To be fair, after a period of fantastic gains it is reasonable to ask if we are presently as close to this light as Icarus got to the sun. It is true that several of our stocks have recently enjoyed large gains. However, in my opinion, it is also true that their valuations remain reasonable or cheap versus their future earnings power, and the present dichotomy in the market between what is expensive and what is cheap has yielded several exciting new investments. Additionally, in most cases our companies still have notable events on the horizon which will force the market to take notice.

For example, consider our “free from” sweeteners business, Whole Earth Brands (FREE), which I introduced in our [Q3’20 letter](#). The stock has appreciated by more than 50% since that time, but in my view the move higher is more reflective of the incredibly low purchase price we were able to exploit rather than a reflection of the business’s true earnings power. While no longer as cheap as it was, at present the company trades around 8x pro forma EBITDA, versus slower growing, lower margin comparable businesses that are exposed to less attractive trends that are trading at 12-14x. We may have moved past the incredibly low purchase price that we originally enjoyed, and management has to execute, but shares would still have to ~double to trade in line with peers. I don’t know when that will happen – although being added to indexes in a few months time will likely help close the gap – but I do know that this is a business whose fortunes are not directly tied to the economic cycle, and I do know that management has easily identifiable levers to pull to continue to improve the business. As such, I think it is cheap enough to own regardless of what else is happening with the broader markets and pockets of excess.

A similar story can be told about each of our stocks that have enjoyed large gains over the past several months. Just because they are not as cheap as they were, does not mean they are expensive. Thus, I think the real risk for us as a partnership is forgetting that perhaps our greatest advantage is patience.

To be clear, our *stocks* are unlikely to be immune in a broad market decline, but as long as our *businesses* continue to perform, at some point in the next 3-5 years I expect that the *stocks* will trade at a normalized multiple of normalized earnings. In the case of FREE, this implies ~100% upside, assuming a properly incentivized and experienced management team fails to find additional ways to increase value. While I have no doubt that our returns will not come in a straight line and that not all investments will work as envisioned, the scenario described above represents a 15-26% annualized return. While doing so would be no small feat, if one were to maintain a 15% annualized return for 30 years a \$1M investment would be worth more than \$66M. If that were to happen, I am confident we would all firmly believe it was the “best of times,” and whatever “season of darkness” we had to temporarily endure on the way would be a distant memory.

New Positions

While I aspire toward sloth, the portfolio has seen an unusual level of activity in recent months, and I have been actively buying several new positions. These investments represent fresh kindling for our portfolio, and run the gamut from quirky special situations that combine essentially zero downside with the potential for a quick win, to potential multi-baggers that are dealing with temporary issues. As I may still actively trade these positions, I will introduce them more formally in future communications.

Top 5 Disclosed Long Positions

Aimia, Inc (AIM.TO) – Despite limited price appreciation, Aimia is likely the portfolio company that made the most significant operational strides over the last year. The company has been fully transformed from a capital incinerator to a lean holding company housing a number of attractive assets managed by highly incentivized capital allocators. In my view, this transformation has not yet been reflected in the stock price because Aimia’s most valuable asset is PLM, the bankruptcy remote loyalty arm of AeroMexico. AeroMexico was forced into bankruptcy by Covid19, however, Apollo, one of the world’s largest private equity groups, has agreed to provide DIP financing, and the company is likely to emerge from bankruptcy with Apollo as its largest shareholder in the near term. There is still considerable uncertainty, but it is nearly impossible to imagine a scenario where Apollo would seek to become the owner of an airline without also wanting to own its loyalty arm, and I suspect that before long the value of PLM will be crystalized, resulting in significant appreciation for Aimia’s stock. At the same time, Aimia’s much improved management team and board will seek out clever ways to deploy the company’s cash hoard and maximize the value of other existing investments.

Avid Bioservices (CDMO) – Long time holding CDMO is entering the next phase of its growth following a recent capital raise that will help finance the expansion of the company’s drug

manufacturing facilities. I expect that the business will remain lumpy, and the stock will have its ups and downs, but the industry remains supply constrained while demand continues to grow, creating an attractive backdrop for continued success. Specific to CDMO, examining the pipelines of the company's key customers suggests continued above industry growth levels.

PAR Technology (PAR) – PAR, our restaurant point of sale (POS) software business, had a wild ride in 2020, first declining more than 60% as people feared that restaurants were doomed, only to rise more than 400% from the lows as people realized that in order to survive, restaurants need to be technology enabled. Despite the runup in price and a valuation that admittedly does not scream cheap, there is still a lot to like here as the competitive position is dominant, the path to continue to grow installs and ARPU is clear, and the strong balance sheet is in the hands of a proven capital allocator.

USA Technologies (USAT) – USAT, which will shortly be re-branded as Cantaloupe, is our unattended retail/vending machine software company that was introduced in our Q3'20 letter. The company saw drastic corporate change in 2020 as a new, properly incentivized, board and management team wrested control from a prior regime that mismanaged the company. The new team has made rapid progress in reining in expenses through refinancing debt and right sizing operations, while also shifting the focus of the business toward its best-in-class enterprise software offering (Cantaloupe) and initiating plans for international expansion. The business is still hampered by Covid, but should improve as life returns to normal, and the stock should benefit in the months to come as the market continues to recognize the operational improvement underway, and from the forced buying that accompanies index inclusion.

Whole Earth Brands (FREE) – Discussed above.

A Brief Word on Taxes

In years past LWC has strived to maximize tax efficiency. However, this year was more challenging. Namely, 3 of our large holdings were acquired prior to reaching long term status, we made money on the short side which is never tax efficient, and several companies purchased during the March panic rapidly blew past my estimate of fair value, resulting in short term sales. If the price of fantastic gains over a short period of time is tax drag, I think it is worth it. I have been in touch with our accountants at Spicer Jeffries, and they are presently hard at work on preparing the fund's audit and K-1s, which should be complete by early March at the latest.

Partners Meeting / Amending of Founder's Class

I recognize that I have been teasing a partner's meeting for some time now, and yet I have failed to set a date and time. The reason for the delay is two-fold. First, I am in the process of making changes to our partnership and service providers that I believe will best position us for success

over the next 3 decades, so I am moving slowly – and slower than anticipated. Second, in a world where our meeting will be taking place online, the necessary lead time is reduced to days or weeks rather than months. In any event, please stay tuned.

Despite the delay in setting a date for our partners meeting, our Founder's Class will be amended as of the end of Q1. Investors who have joined us prior to that time will be grand-fathered into our existing terms, while subsequent investors will be required to agree to an extended lockup to enjoy our lowest fee structure. If you are aware of individuals who have been considering joining our partnership, please let them know of the pending change.

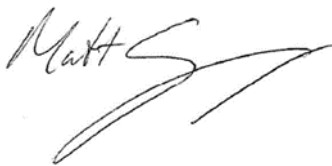
Going Forward

If you listen to the financial press (I don't) there has been a fair bit of chatter about asset bubbles lately, with commentators pointing to a market multiple which is elevated vs. history and a record valuation spread between the best stocks and the lesser stocks as evidence. From my perspective, while these elements do not form a backdrop that appears cheap, it is not clear to me that these factors are at all relevant.

Several decades ago the "worst" companies were capital intensive and cyclical, and the best companies put processed grains in boxes with recognizable labels. In today's world, the "worst" companies are still capital intensive and cyclical, but the best companies require no incremental capital to provide services that would essentially be considered magic if someone from several decades ago were to see them today. Is it any wonder that with this "magic" now part of the equation that valuation spreads between the best stocks and the lesser stocks is at record levels? And is it any wonder that these companies sport higher multiples, and thus skew the market multiple higher than it has been in the past?

To be clear there are some areas of seeming excess which are worth being aware of, such as BitCoin, the proliferation of SPACs, and manic IPO behavior. Yet, for each of these potential excesses, there are areas of the market - and certainly individual stocks - which in my view still represent the potential for very attractive returns going forward. As always, these returns will not come in a straight line, and it is impossible to guarantee that areas of seeming excess will not end poorly and contagiously. However, by proactively choosing to ignore and/or take advantage of any potential volatility, I remain confident that our future is bright.

Please let me know if you have any questions,



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