Mutoro Group Partners, LP
Full Year 2018 Letter

February 11, 2019

"Put simply, a high P/E ratio suggests stocks are overpriced and are likely to underperform, whereas a low P/E indicates the opposite. An investor who is diversified among asset classes might exploit this by decreasing his allocation to stocks when P/Es have been historically higher and shifting more into stocks when the P/Es have been lower." - Ed Thorp

"For this reason, it's important to note that exiting the market after a decline — and thus failing to participate in a cyclical rebound — is truly the cardinal sin in investing. Experiencing a mark-to-market loss in the downward phase of a cycle isn't fatal in and of itself, as long as you hold through the beneficial upward part as well. It's converting that downward fluctuation into a permanent loss by selling out at the bottom that's really terrible." - Howard Marks

"It's all a process, steps along a path. Becoming requires equal parts patience and rigor. Becoming is never giving up on the idea that there's more growing to be done." - Michelle Obama

Dear Partner,

Because we currently have a meaningful portion of our portfolio in cash, and because we would like to put that cash into more attractive long-term investment opportunities, in the near-term, falling securities prices are probably great for us. I do not write this as a near-term prediction of things to come. We have no crystal ball. We are not in the business of making predictions; we are in the business of making preparations. As such, it would probably be unwise to overly focus on what is going to happen as regards the economy or the general level of securities markets in the next month, the next quarter, or the next year. Timing the occurrence of near-term price fluctuations in our individual holdings and markets as a whole is something probably outside of our skillset.

What is more likely to be within our skillset and to be within our control is how prepared we are for whatever happens in the future. We can prepare through how we structure the composition of our portfolio. We can also structure our operations such that we are not forced to turn temporary, paper losses—from transient fluctuations in the prices of our securities holdings—into permanent losses. I am comfortable with taking temporary paper losses on a monthly, quarterly, or annual basis if it means real, tangible gains we can keep on a multi-year basis.

To expand the size of our portfolio over time and the portion of your wealth you have entrusted me to manage, I have since our inception sought to buy equity or equity-linked derivative securities. And I have sought to do this at prices that I judge attractively discounted to the value of the underlying businesses those securities represent. When we cannot find attractive deals on securities, we have been comfortable holding cash. Cash has its benefits and its drawbacks. I have previously written that cash is "often the best short". We have held cash as equity markets reached all-time highs and holding cash seemed very, very unpopular. When falling prices have rendered securities more attractively priced relative to their value, we have moved some of that cash into those securities. We have done this because we believe that in the long-term, equity and equity-linked derivative securities are preferable to cash; moreover, the

prices of those securities will eventually match the growing value of the underlying businesses they represent. This is what we have attempted to do every year of the Partnership to date.

Doing this we have had both welcome successes (See Full Year 2016 Letter) and unwelcome missteps (See Full Year 2017 Letter). Given my central role to the operations of the Partnership, I take credit and blame for both. I believe because we are a learning organization, we are getting better at doing this every year. Ironically for us, it is tougher to do what we do well in peaking markets. Rather than turn despondent, this makes me look forward to the opportunities that would present themselves should markets head down. It also makes me pleased with how we performed this year. Because of those unpopular preparations in prior years, we were able to protect the principal of our investment capital and begin to plant the seeds to take advantage of recent share price fluctuations.

We added four new holdings this year. Each was a company that had seen its share price plummet dramatically this past year. The first, Company G (11.3% of our total portfolio at year-end), I described in detail in our Q2 2018 Letter. I referred to it as a holding company for several leading digital brands that sell online recurring subscriptions in what is a relatively nascent market but an evergreen field of human activity. The second, Company H (10.2% of our portfolio), I described in our Q3 2018 Letter. We also in December entered two additional ownership positions in companies after the prices of their securities plummeted along with the broader markets; we acquired a Company I (5.3% of our portfolio), a large American-based global financial services firm, and a Company J (2.7% of our portfolio), a digital conglomerate of disruptive software applications and consumer hardware businesses.

While all four new holdings fell in tandem with the broader markets this year, they fell significantly more than the broader markets for their own reasons. Companies H, I, and J fell because of increased fear by the marginal investor over possible regulatory fines and penalties those companies might face. These fears I think are valid but vastly overdone, especially when you weigh the fundamental profit engines of these remarkable businesses, which continue churning unabated. We also at year-end still owned Company C (2.7% of our portfolio), which we first purchased in 2015 and is an American manufacturer of equipment used in the construction and automotive industries; I described it in detail in our Full Year 2016 Letter. And we still owned Company F (10.9% of our portfolio), which we first purchased in 2017 and is the U.S.-based leader in a large, consolidated industry with high regulatory and economic barriers to entry and scale. The remainder of our portfolio was in cash (56.7% of our portfolio).

The exhibit below summarizes our portfolio composition at year-end:

Cash and Cash Equivalents	56.7%
U.S. Public Equities	43.3%
Total Portfolio	100.0%

Table 1. Portfolio Composition

As I wrote in our Q2 2018 Letter, we tend to look for businesses that are "typically (a) highly cash generative, (b) the dominant or a key player in an industry (whether large or small), and (c) priced such that the expected value of a successful outcome outweighs the probability and magnitude of downside risks." Moreover, all of our holdings have strong balance sheets, business models, franchise values, and prospects. If you calculate the average revenue growth, gross margins, and operating margins for each our holdings over the last three years, as a group they have an average revenue growth over the past three years of 18.0 percent, gross margins of 59.6

percent, and operating margins of 27.2 percent. These are great businesses. I also think we bought them at good prices.

Each of these businesses also has management teams who have demonstrated a willingness and ability to play the long game, even when it has proved very, very unpopular. They have each shown a willingness to enter or establish new geographic and product markets and sometimes to wait ten years or more nurturing profitable offerings around new customers. As I wrote in our Q3 2018 Letter,

> All of our current crop of managers understand trade-offs in capital allocation. In pursuit of higher margins and more durable cash generation over the long-term, they are willing to sacrifice margin in the short-term, even if it means the share price of their business takes a beating. It is my job as an investor to find and maintain the patience in our operations and attitude to take advantage of that temporal discrepancy between our managers doing the right thing and us being rewarded for it.

With what we know presently about our current holdings and their competitive positions, each seems likely in five to ten years to be more cash-generative and valuable than it is today. Their share prices should in time reflect this.

Stepping back for a second, I have to admit it was somewhat challenging writing this letter last year. Markets were reaching all-time highs and seemingly every marginal investor on Wall Street was celebrating themselves and their supposed investment genius. Meanwhile, our portfolio, largely parked in cash, was lagging as expected, but with no help from a poor investment decision I made in China. After almost doubling the market in 2016, we lagged considerably in 2017, and I was disappointed. But I also knew that was likely to change, as the heady optimism obvious in the price of indices and company shares (and even cryptocurrencies) would eventually give way. And it did.

For the calendar year of 2018, the fund finished down 2.39 percent net of fees and expenses. For context, the S&P 500 was down 4.39 percent for the year including dividends, the first broad bear market in a decade, as the S&P 500 dropped 20 percent from a 52-week high. It is worth remembering that through the first nine months of 2018 we were up 4.85 percent net of fees and expenses. From that point through the end of the year, Company G contributed the most to our temporary loss on an annual basis, its share price declining 24 percent during the fourth quarter. Despite its share price fluctuations, the underlying business continues to increase its earning power.

*****

Given my central role to the operations of the partnership, I think it worthwhile to mention some important events in 2018 that occurred in my life. In May, I became an uncle again as my older brother Karani and his wife Sophal welcomed to the world my incredible nephew Evan. You might remember that in my 2015 Annual Letter I mentioned how we welcomed Evan's wonderful older brother Gabriel to our lives that year. Given that Gabriel and Evan both cannot yet read or write, I think it is probably too early for me to introduce them to the concepts of value investing. But please do not be surprised if I report that they receive Roger Lowenstein's biography of Warren Buffett as a Christmas or birthday gift sometime in the next few years. (For better or worse, I am one of those relatives that gifts books.)

In other relevant book-related news, in 2018, I read 37 books; I mention this because I have written brief book reviews for some of these on the *Notes & Letters* section of the Mutoro Group website. Some of these books were excellent memoirs or tales of business scandals by the world's best entrepreneurs and journalists (e.g., *Shoe Dog* by Phil Knight, *What I Know for Sure* by Oprah Winfrey, *Evicted* by Matthew Desmond, and *Bad Blood* by John Carreyrou immediately come to mind), while others were novels by some of the world's greatest writers (e.g., *Moby-Dick; or, The Whale* by Herman Melville and *The Underground Railroad* by Colson Whitehead). I think both nonfiction and fiction are worth reading as I try to become a better investor, thinker, businessman, person, and communicator. I always take something valuable from a book I finish, whether or not I adored reading it. I write the reviews because I have found that trying to put in my own words a reflection on what I read helps me remember it and understand it better. A full list of the books I read last year is attached to this letter after my signature. If you have read any of these books as well and want to discuss them or have other books you think I would benefit from reading, please let me know.

I am working with our third-party administrator NAV Consulting Inc. and our outside auditor Spicer Jeffries LLP to have your K-1s to you as soon as possible, with a likely delivery either at the end of this month or by the middle of March. Should this present any difficulties for you, please let me know.

Thank you for your partnership, your confidence, and your trust. Please feel free to email me or call with any questions or comments. I look forward to seeing what opportunities this year affords us and working hard to ensure we're prepared to take advantage of them.

Sincerely,

Godfrey M. Bakuli
Managing Partner

BOOKS READ IN 2018

Favorite books of 2018, in the order I read them:

Mindset
by Carol S. Dweck, Ph.D.

The Illustrated Man
by Ray Bradbury

The Emperor of Water Clocks
by Yusef Komunyakaa

Big Money Thinks Small
by Joel Tillinghast

The Innovator's Dilemma
by Clayton M. Christensen

Make It Stick
by P. Brown, H. Roediger III, and M. McDaniel

What I Know for Sure
by Oprah Winfrey

Sapiens
by Yuval Noah Harari

Bad Blood
by John Carreyrou

Evicted
by Matthew Desmond

The Underground Railroad
by Colson Whitehead

Thinking in Bets
by Annie Duke

The Signal and the Noise
by Nate Silver

Mastering the Market Cycle
by Howard Marks

Becoming
by Michelle Obama

Friday Black
by Nana Kwame Adjei-Brenyah

Shoe Dog
by Phil Knight

Moby-Dick; or, The Whale
by Herman Melville

Never Split the Difference
by Chris Voss

Homo Deus
by Yuval Noah Harari

How to Become a Rainmaker
by Jeffrey J. Fox

Other books in 2018, in the order I read them:

All the Names
by José Saramago

Letters from a Stoic
by Seneca

Silencer
by Marcus Wicker

The Tree
by John Fowles

Managing Oneself
by Peter F. Drucker

The Old Man and the Sea
by Ernest Hemingway

The Power of Habit
by Charles Duhigg

The Million-Dollar One-Person Business by E. Pofeldt

Scarcity
by S. Mullainathan and E. Shafir

"What Do You Care What Other People Think?"
by Richard P. Feynman

Emotional Agility
by Susan David, Ph.D.

The Match King
by Frank Partnoy

The Remains of the Day
by Kazuo Ishiguro

Atomic Habits
by James Clear

Plunkett's Almanac of Middle Market Companies
by Jack W. Plunkett

A Dozen Lessons for Entrepreneurs
by Tren Griffin