Mutoro Group Partners, LP
First Quarter 2020 Letter

May 14, 2020

"I wish it need not have happened in my time," said Frodo.
"So do I," said Gandalf, "and so do all who live to see such times. But that is not for them to decide. All we have to decide is what to do with the time that is given us."
– J.R.R. Tolkien, *The Fellowship of the Ring* (1954)

"I tried to look ahead by decades rather than by quarters, and to rebut economists who contended that the advanced economies were doomed to subpar growth for a long time. I told the graduates, 'Both humanity's capacity to innovate and the incentives to innovate are greater today than at any other time in history.' In short, I tried to convince them that the New York Yankees Hall of Famer Yogi Berra was wrong when he said that the future ain't what it used to be."
– Ben S. Bernanke (2015)

Dear Partner,

As I write this, my first thoughts concern your well-being. I hope you and your loved ones are holding up alright while we all deal with the challenges of the pandemic. From where I write, the ambulance sirens outside my home in Brooklyn that were so constant in early April have quieted down a bit. However, the threat of coronavirus clearly lingers as spring emerges in New York. The walks I take with my 11-year old border collie Caspi have been both a welcome respite to being indoors since March and a fraught reminder of how much life has changed recently. News of the tens of thousands of New Yorkers who have passed away is similarly a horrific reminder to heed sensible public health guidelines. While I have spent much time this year learning about such guidelines and the health risks of the contagion, I am no expert in such matters. As a result, that will not be the focus of this letter. I am an investor, and my skills are in investigating business opportunities, developing strategies, and making capital allocation decisions. This letter will focus on what I try to know best.

How to describe our Q1? Like the yeast being prepped for your lockdown sourdough bread, we were active. Some useful context first: As I wrote in my last letter, the fund finished 2019 up 24.0% net of all fees and expenses. We began 2019 with 48.5% of the fund in cash, and we finished with 37.4% in cash. We ended the year with nine portfolio holdings. For the first quarter of 2020 ending March 31, the fund finished down 18.5%, with 9.1% of the fund in cash. We had 13 portfolio holdings by quarter end.[1] March was a busy month for us.

It is my opinion that the first quarter's results were heavily influenced by near-term fluctuations in prices for most of our holdings but did not forebode permanent weaknesses to their business models. For some, their long-term competitive positioning may even strengthen. Instead of focusing on how the aggregate market price of the portfolio fluctuated, it would be more useful to instead focus on our process in some key areas of activity. To do

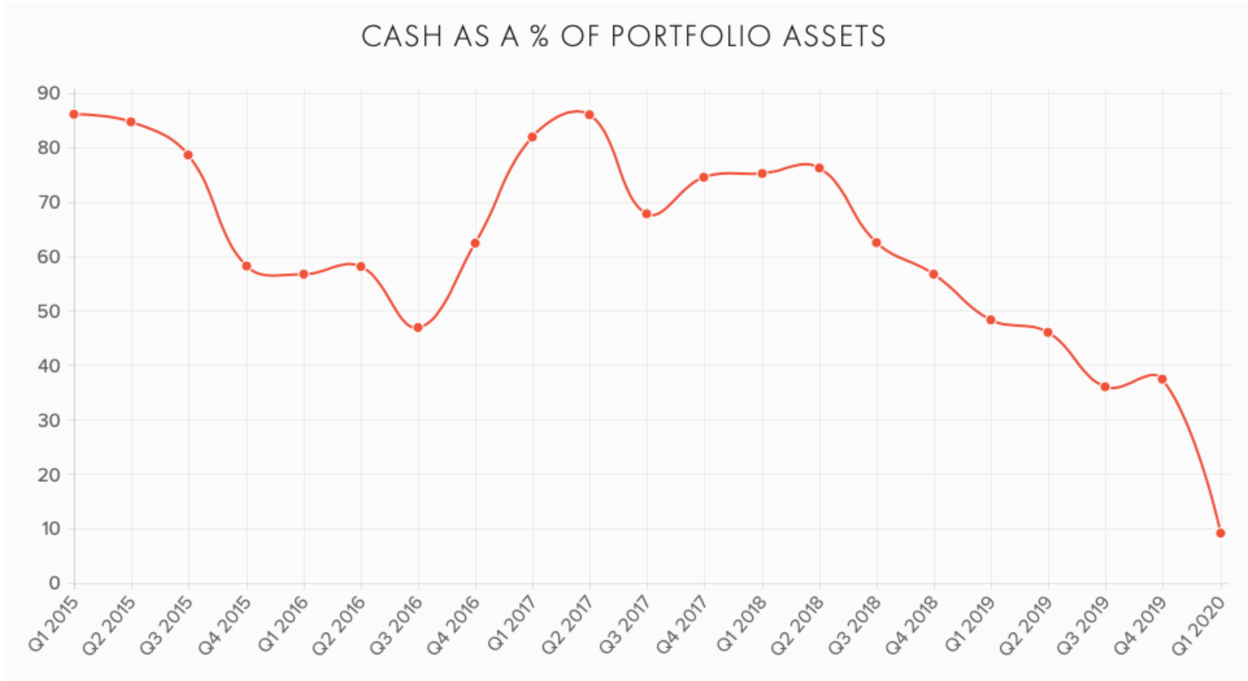
1 For further context on the market volatility underway, year-to-date through April the fund would be down 9.4%. Our portfolio rose in April through investments we made and the re-appreciation of our holdings. Cash as a percentage of the portfolio would be 10.7%, having risen mostly because of new subscriptions.

this, I will place key activities into three groups: Strengths, Weaknesses, and Unclear / Time Will Tell. Let us review these in that order.

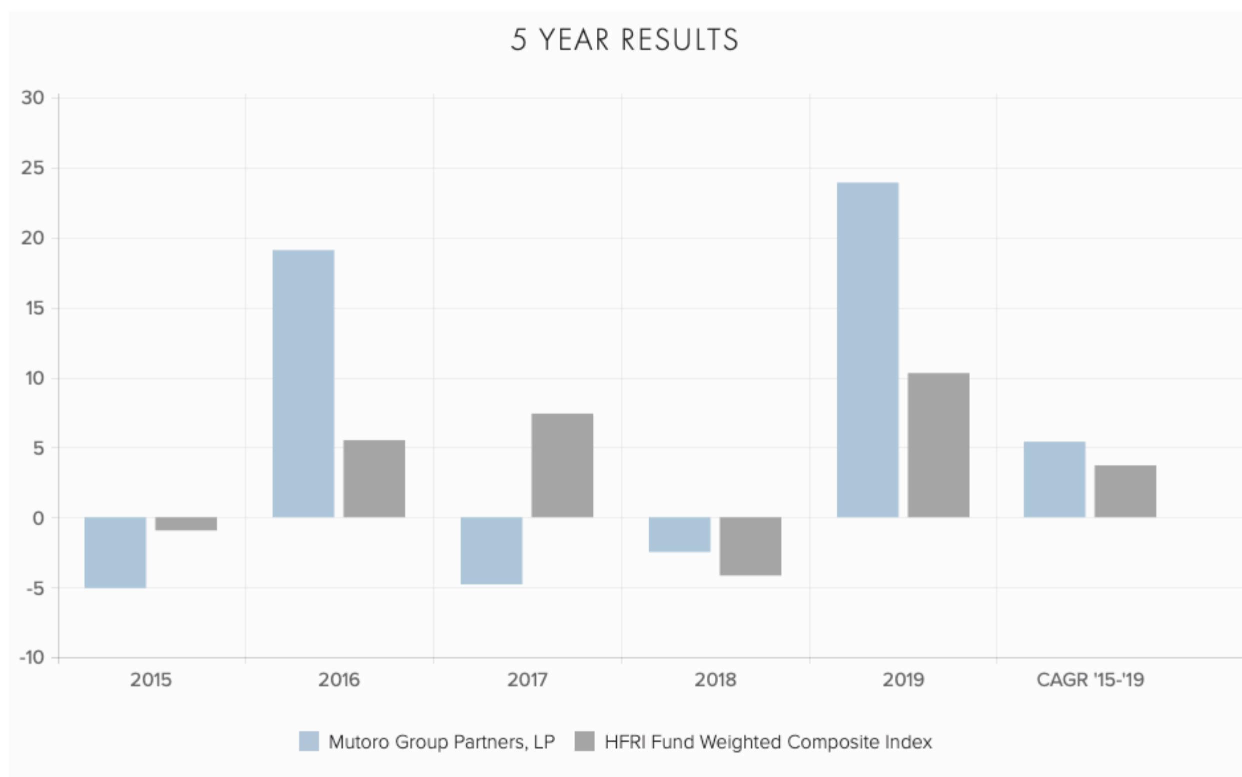
Strengths

Cash Management

Since the fund began investing in January 2015, equity markets in the United States have continually broached new all-time highs. Throughout this period, I have consistently been comfortable with us holding substantial cash as a portion of our portfolio. I am thankful for your partnership in allowing this. The chart below shows our cash over time.



Cash has served us two main benefits. Firstly, it is a de facto (though inefficient) short position against lofty market valuations. Secondly, it helps us prepare to take advantage of falling market prices. Most notably, in 2016 and late 2018, we used our cash to buy into individual companies whose prices became attractive because of scandals idiosyncratic to them. From the vantage of 2020, it would be untrue for me to claim we held cash over the last five years because I specifically anticipated disruption from a global pandemic. But one not need be specific about risks to be smart about managing and preparing for them. While holding cash in these percentages was not a popular position to take during the last five years, and restrained us in competition with market indices, risk-adjusted we still achieved attractive returns. Through 2015-2019 we bested an index of peer funds.



While much of the investing world decided in Q1 that holding cash was in vogue, our prior prudence allowed us in March to become active acquirers of what they were selling to raise cash. We added to most of our existing holdings and acquired four new holdings. This is not to say that we have emptied our tank. We still have cash as a percentage of our portfolio that most professional investors do not have the stomach or ability to hold.

Bias toward "Growing Pies" over "Cheap, Shrinking Pies"

At the risk of stretching an analogy, let us talk briefly about pizza. Imagine a favorite pizza order from a beloved local restaurant. (Mine is a large 16-inch pizza from *John's of Bleeker Street* in Greenwich Village. As regards toppings, I am partial to sliced meatballs, mushrooms, peppers, and onions.) Now imagine the worst pizza you have ever had anywhere. (Mine is the vending machine *Hot Pocket Pepperoni Pizza* I once had at a Cincinnati hotel after a red-eye business trip.) When the fund first started, far too much of our portfolio was in slowly growing, highly levered companies. What attracted me to them was that despite the ugliness of their business models, they seemed to be priced *too low* relative to their intrinsic value and my analysis of their actual solvency risk. We can call these "Cheap, Shrinking Pies". While I was able to purchase their shares at attractive prices and eventually sell for a profit, I soon grew confident that the roller coaster ride in price (and potential bankruptcy) was less attractive than an alternative. Namely, given our long-term investment horizon, instead of buying into businesses that are slowly shrinking and very cheap, I would rather acquire fairly priced interests in businesses that are dominating their competition and growing strongly over time at high returns on invested capital. We can call these "Growing Pies". In the spring of 2018, I began positioning our portfolio much more toward them. We are still in the early innings of yielding the benefits of that. When we were active in March, for the most part I added positions in companies that I believe are Growing Pies.

Long-Term Focus

In my experience I have found, as you might expect, that the best way to make good investments in the long run is to keep long run thoughts in the forefront of your mind. Notably, a company's long-term competitive positioning. Ironically, I have also found that investments that end up looking best in the short run come also from thinking about the long run (even if looking good in the short run is not the goal). A recent event highlights this.

On March 18, I initiated a position in a company you can read about in more detail in the Limited Partner addendum to this letter. I liked the company's 17 straight years of double-digit revenue growth, its role in establishing and leading a rapidly growing market, its highly cash-generative business model, its industry-leading margins, its debt-free balance sheet, its possession of cash totaling six years of fixed operating expenses, and its recent expansion into overseas markets. A negative against it is that it is a consumer retailer, and consumers are generally struggling right now. In its favor, though, it does have an exceptionally strong brand. It also sells a high-quality product to relatively well-heeled consumers who will be, generally speaking, better insulated than average from the worst of this crisis. Additionally, the company had been investing in growing its already sizable and higher-margin e-commerce sales (one-third of revenue), which should benefit it in a post-pandemic world.

When I bought the shares, they had halved in price in less than a month. I did not think the shares "cheap". I thought them now "fairly priced". I thought this given the business's clear competitive advantages, strong operations, and healthy balance sheet. The unprecedent magnitude and speed of fiscal and monetary stimulus in March gave me confidence that capital markets would remain open to the company should it need to raise capital to sustain its operations (a possibility that currently is unlikely). From March 18 through the end of April, the shares have risen 62% and even higher since. I expect them to fluctuate.

Weaknesses

Underinvestment in Marketing to New Limited Partners

Over the last five years, despite occasional bouts of energy marketing the Mutoro Group, I have not been consistent in marketing the fund to raise new limited partner capital. This is not to say I have done nothing. But it has not been enough. I am more focused on maintaining a sound investment process than in enticing new capital, doing things such as not disclosing our holdings to non-LPs so I do not have to enter into unnecessary debates about my decisions and can instead focus on research and allocation. Depending on your perspective, it is either ballsy or foolish to want your results to speak for themselves, especially during a bull market, when rising indices and levered competitors often speak louder.

After our strong results last year, I intended to parlay that success into building relationships with more potential limited partners. This is important because one of my allocation strategies benefits from the flexibility to maintain a healthy cash balance. But as news of coronavirus steadily rose in January, my energy naturally turned away from establishing and maintaining contacts toward re-analyzing what we owned and finding new investments. The challenge with this is should the worst economic repercussions of the pandemic and lockdown last multiple years, we may not have the benefit of new capital to

continuously take advantage of it. This is the challenge of any investment manager but all the more pronounced when you do not have a team to market for you. I will solve this; it is a weakness of the process I need to address.

Unclear / Time Will Tell

Airline Holdings

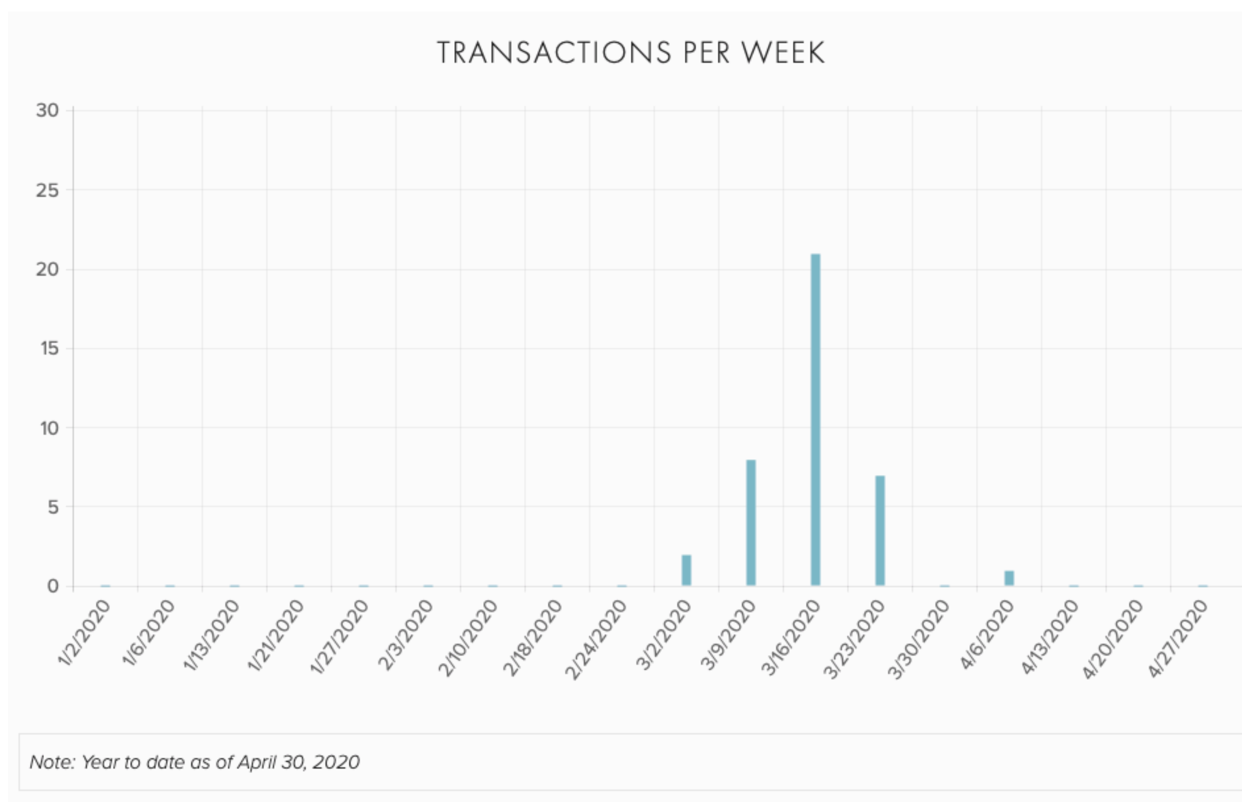
At the end of the quarter, we owned stakes in the two airlines that I currently believe have the highest chances among their publicly traded peers of surviving the worst period in the history of the industry. By the end of April, those two were in total 4.5% of our entire portfolio.

Some airlines have already declared bankruptcy around the world and others will likely follow. News stories on the industry jump from this likelihood to the conclusion that the chances of survival for all airline equity is zero. But it is not today a foregone conclusion that *all* will go bankrupt. Pessimists might be ultimately right, but I think they are flawed in seeing all the businesses as the exact same. They have different balance sheets, different cost structures, and different leadership teams. Those things usually matter in business. Consequently, they usually matter in investing. I cannot say for sure that we will maintain our holdings through year-end. It is very possible these two positions are remnants of the *Hot Pocket Pepperoni Pizza* lifestyle I have disavowed. Thankfully, our other holdings (i.e., +95% of our portfolio) likely have higher odds of success.

Active Buying on the Darkest Days

There is a notion in psychology of *kind* and *unkind* learning environments. Kind learning environments are those in which the rules are relatively consistent and the feedback frequent. Examples of this include games like basketball or soccer. It takes seconds to know if a specific shot attempt was successful, allowing you to quickly adjust your playing strategies. Similarly, the rules do not vastly change every time you enter a new arena, meaning there are limited new variables to understand each game. Investing is generally considered an *unkind* learning environment. You may not learn definitively for months or years (or ever) whether the process behind a purchase was intelligent. Whether the purchase itself was ultimately successful may be for reasons unrelated to your original thesis. As such, it is probably premature for one to say whether purchases made in Q1 2020 will prove intelligent or not. The answer to such a question depends largely on one's holding period, what is purchased, and the prices paid. That said, I believe there are many ways to go about investing to make an environment kinder. One is to have a sense of what a target company is worth before crisis hits so you can see opportunity in falling prices rather than just peril. Another is to do your homework on holdings and targets to gain confidence they are likely to remain solvent and have the liquidity at hand to weather a prolonged period of dislocation. This is what we did. After doing this, we invested.

The following chart shows the weeks in Q1 and the number of investments we made in each. It shows that we can be very patient. It also shows that we can strike when uncertainty is at its highest, fears of a financial crisis are spiking, and prices are falling dramatically. If we were to wait to purchase until there were a public consensus that the worst was behind us, we would be unlikely to obtain good deals. Of course, if the worst is ahead of us, an unclear fact that time will tell, it is good that we still have cash.



The exhibit below shows the composition of our portfolio at the end of Q1:

Cash and Cash Equivalents	9.1%
European Public Equities	15.6%
U.S. Public Equities	75.3%
Total Portfolio	100.0%

Thank you for your trust and your partnership. I hope you and your loved ones are healthy and safe and stay that way through this difficult period in history. Please feel free to email me or call with any questions or comments. I look forward to someday seeing you again.

Sincerely,

Godfrey M. Bakuli
Managing Partner