Mutoro Group Partners, LP

Third Quarter 2018 Letter

November 11, 2018

"Just stay busy, stay working. Puff told me, like, the key to this joint—the key to staying on top of things—is treat everything like it's your first project, nomsayin'? Like, it's your first day, like, back when you was an intern. Like, that's how you try to treat things like, just stay hungry."
— The Notorious B.I.G. on the intro to "My 1st Song" by Jay-Z

"What I know for sure is that the only way to endure the quake is to adjust your stance. You can't avoid the daily tremors. They come with being alive. But I believe these experiences are gifts that force us to step to the right or left in search of a new center of gravity. Don't fight them. Let them help you adjust your footing." — Oprah Winfrey

"The investor with a stock portfolio having such book values behind it can take a much more independent and detached view of stock-market fluctuations than those who have paid high multipliers of both earnings and tangible assets. As long as the earning power of his holdings remains satisfactory, he can give as little attention as he pleases to the vagaries of the stock market. More than that, at times he can use these vagaries to play the master game of buying low and selling high." — Benjamin Graham

Dear Partner,

Thank you. I try to emphasize gratitude in my life and habitually end these letters to you with an expression of appreciation for your confidence and support. But today, I wanted to do something different and start this letter to you with one. I do this because it was ten years ago, on November 11, 2008, a Veterans Day like this, that I bought my first share of stock in a company. As I reflect on the anniversary of what is a very special day in my life as an investor, I am in an especially thankful mood.

Before I bought that first share, I had spent months reading everything I could about "how to invest." In any spare moment, I poured through the writings of investing greats like Warren Buffett, Benjamin Graham, Charlie Munger, Seth Klarman, and others. In the back of my mind was the kernel of a bold ambition that perhaps someday all that study, which culminated in the decision to use my own money to become the owner of a real business, could with time lead to where we are today—having partners such as you who have trusted me to manage some of their wealth. For our partnership and your trust, I am deeply grateful.

I will try to write more for the Notes & Letters section of the Mutoro Group website about how I came to investing and the principles that helped me in my first decade as an investor and that continue to guide me into my second. But I will say now that I often have felt very fortunate that I learned to invest during the global financial crisis as it was probably the greatest time to become an active student of the art. When markets are hitting fresh highs and capital flows effortlessly, it is easy to feel like a genius and to think you are brilliant at portfolio management and security selection. It is also somewhat easy, if you have the cash and the courage, to be an aggressive buyer when markets are finding new lows and panic and worry represent the mood of the moment. But the hardest and most valuable behaviors are to keep enough emotional discipline through both types of environments, to keep a long-term view of how things can change, and to act thoughtfully in preparing yourself for a future that could be materially different from the recent past.

The biggest challenge in investing in the public markets for most people who seek to make a living this way is usually not whether they have the intellectual aptitude. The principles of management, accounting, finance, business and market analysis, and capital allocation are not arcane if one is willing to spend the time to understand them. The biggest challenge has always been managing oneself, particularly one's present emotions, especially because of how easy it is for us as humans to let fleeting influences infect our rationality, to seek social confirmation for our decisions rather than move through the world independently, and because the feedback one gets on whether one is making sound decisions is often very delayed. In the last ten years, I have gone through sometimes staggeringly heavy tests in each of these areas, and I am grateful to have emerged on the other side of them optimistic and stronger. The tests I have faced and the challenges I have overcome have shown me that I should always bet on myself to have the fortitude necessary to learn, to thrive through different market environments, and to play what Benjamin Graham described as the "master game."

We finished the first nine months of 2018 up 4.85% net of fees and expenses. The exhibit below summarizes our portfolio composition at quarter end:

Cash and Cash Equivalents	62.5%
U.S. Public Equities	37.5%
Total Portfolio	100.0%

Table 1. Portfolio Composition

In the third quarter, we initiated a new position in a business we will call Company H. While Company H has a very straightforward business model, I find it very hard to describe to the general, non-Partner reader without giving away exactly what Company H does. Readers of these letters through the years know that I use pseudonyms to describe our holdings so I can remain independent-minded in my analyses of them. As I described in my 2016 annual letter:

> Every limited partner knows the actual names of the companies we own and also receives the investment memos on them I wrote at the time of purchase. The memos answer those two all-important questions: "Why am I buying this?" and "What is it worth?" I regularly revisit and attack the assumptions in those. But there are many readers of these letters who are not partners. Whether these readers would know our companies well, they have one thing in common, which is a social relationship with me. And it would not be surprising if they had strong opinions on these companies, as each one has been at some point unloved by the public. Unsolicited opinions are dangerous for us, especially if we value independent judgment; because even the well-informed might have different capital allocation priorities, coloring their views. You know this feeling if you have ever been a member of a book club: You gather with a group of peers of similar IQ and aptitude, yet are shocked at the vast and baffling spectrum of responses to literally the same text—not to mention the surprising lengths people can go to persuade you of their views. So I can spend my time analyzing our holdings instead of defending them socially, we use pseudonyms.

I will say this about Company H: It is the dominant company in an industry it helped create and this year suffered two particularly massive declines in its share price. The first decline was brought on by shareholder concerns with Company H being the target of increased regulation;

the other decline by the business undergoing a transition from one incredibly lucrative product line (in which it is competitively dominant) to a newer, (currently) less-profitable product line (in which it is also competitively dominant).

The share price of Company H recovered significantly after the first steep fall, as market participants overcame their earlier handwringing regarding the political fortunes of the company. This seemed to be a pretty sensible response by market participants. For many businesses, the threat of regulation is a death knell. But for a rich, dominant company like Company H, regulation is often a godsend. Increasing the cost of doing business and the hurdles to providing safe, secure, and reliable service raises the barriers to entry for poorer competitors and widens the moat of the entrenched, who can afford the new mandates more easily. I want to think this rational assessment was in the mind of my fellow investors. But who knows for sure why they do what they do in the short-run; I certainly did not survey them. The company's share price has not recovered after its second and much-larger fall related to concerns around the company transitioning to new and less-profitable revenue streams. It was after this second decline that we became owners.

I see more opportunity here than peril. If you are going to own a business undergoing a meaningful transition, it is pretty rare and lovely to own one as lucrative as this, priced like this. It is still growing its revenue at above 20% a year, earning 30%+ net income margins, has no debt, has cash in the bank equal to 10% of its current market capitalization, is spending 1% of its current market capitalization a quarter on share repurchases, and is selling for less than 19 times its earning power.

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.

Thank you again for your partnership and for trusting me with your capital. I am available for any questions or comments you may have.

Sincerely,

Godfrey M. Bakuli

Godfrey M. Bakuli
Managing Partner