



Q2 2019 Masonry All Cap Select Commentary

September 2019

“What the wise man does in the beginning the fool does in the end.”

To our Client Partners:

First and foremost, we want to thank you for partnering with us to manage your investments - it is a privilege we take very seriously. Our flagship strategy, the Enhanced Core Strategy, in place now for over 11 years, has been renamed Masonry All Cap Select. This coincides with the launch of Masonry Capital Management in 2018. We hope this letter helps give meaningful insight into our current thinking and positioning.

Overview of the Portfolio

We currently have a portfolio that contains multiple companies in various industries trading for 6x earnings or less. In fact, over 40% of our holdings fall into this category. To say that is unusual would be doing this anomaly an injustice. In all my years of investing I have never been able to own this many securities trading this cheaply. Post the high inflation years of the 1970's, even in the worst of times, very few companies with growing revenues and earnings, free cash flow generation and valuable assets ever trade below 10-12x EPS. The bifurcation between the obscenely richly valued and the ridiculously cheap is wider than we have ever experienced. We have been able to make investments in a long list of companies in various industries, seemingly every month, that are very inexpensive relative to their near-term and long-term prospects.

Examples of what we own and are currently researching and their respective multiples:

Category	# of Investments	Range of Multiples
Regional, well-run banks	2	10x EPS
Insurance companies	2	3-4x EPS
Media & Content producers	5	3-7x EPS
Automotive	1	4x EPS

We are of the opinion that the market generally doesn't give away investments. There has to be an extraordinary set of circumstances in place to provide these types of opportunities and we believe this is the case at present.

This was taken from Warren Buffett's Partnership letter in 1959:

*Most of you know I have been very apprehensive about general stock market levels for several years. To date, this caution has been unnecessary. By previous standards, the present level of "blue chip" security prices contains a substantial speculative component with a corresponding risk of loss. **Perhaps other standards of valuation are evolving which will permanently replace the old standard. I don't think so (our emphasis).** I may very well be wrong; however, I would rather sustain the penalties resulting from over-conservatism than face the consequences of error, perhaps with permanent capital loss, resulting from the adoption of a "New Era" philosophy where trees really do grow to the sky.*

We share a similar philosophy and mindset with regard to both investing and today's market. Simply put, the lower the price you pay as compared to the calculated intrinsic value the higher the expected return and the lower the risk of a permanent loss of capital. We remain amazed at how financial market cycles and market psychology rinse and repeat through time.

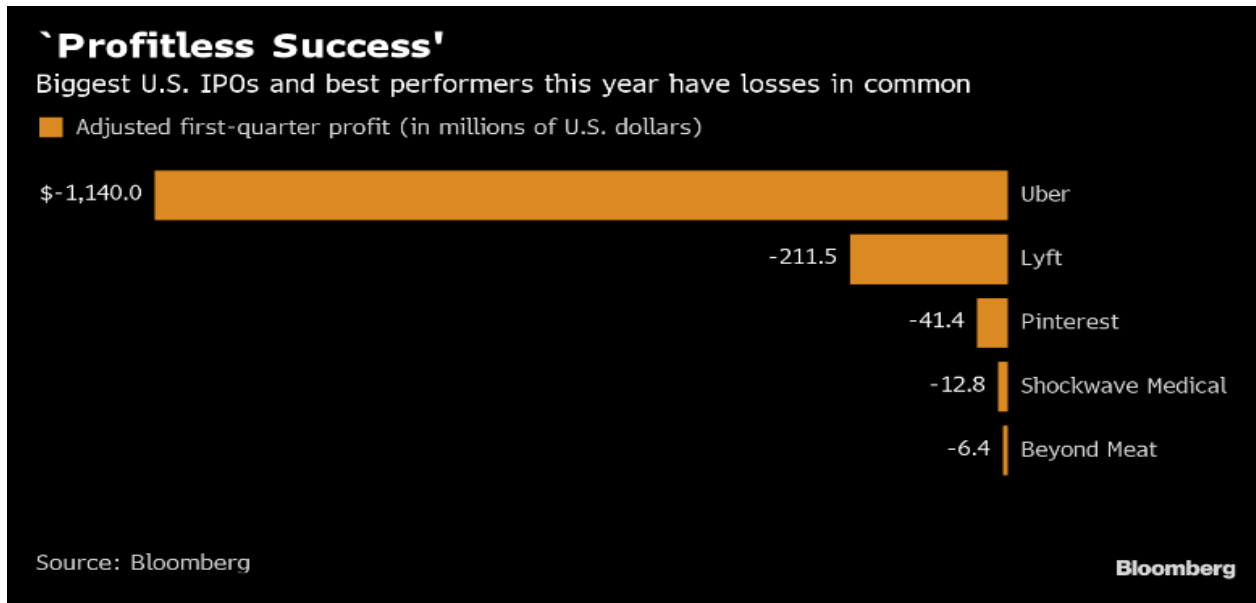
Market Thoughts and Observations

We have wondered aloud with some regularity this year and last, how so many of the obvious and painful investment lessons from the relatively recent past could be ignored today so freely and easily. It is not uncommon in the later stages of a bull market (ours is now over 10 years old) to see behavior that is increasingly irrational, driven in part by excessive optimism and the fear of missing out.

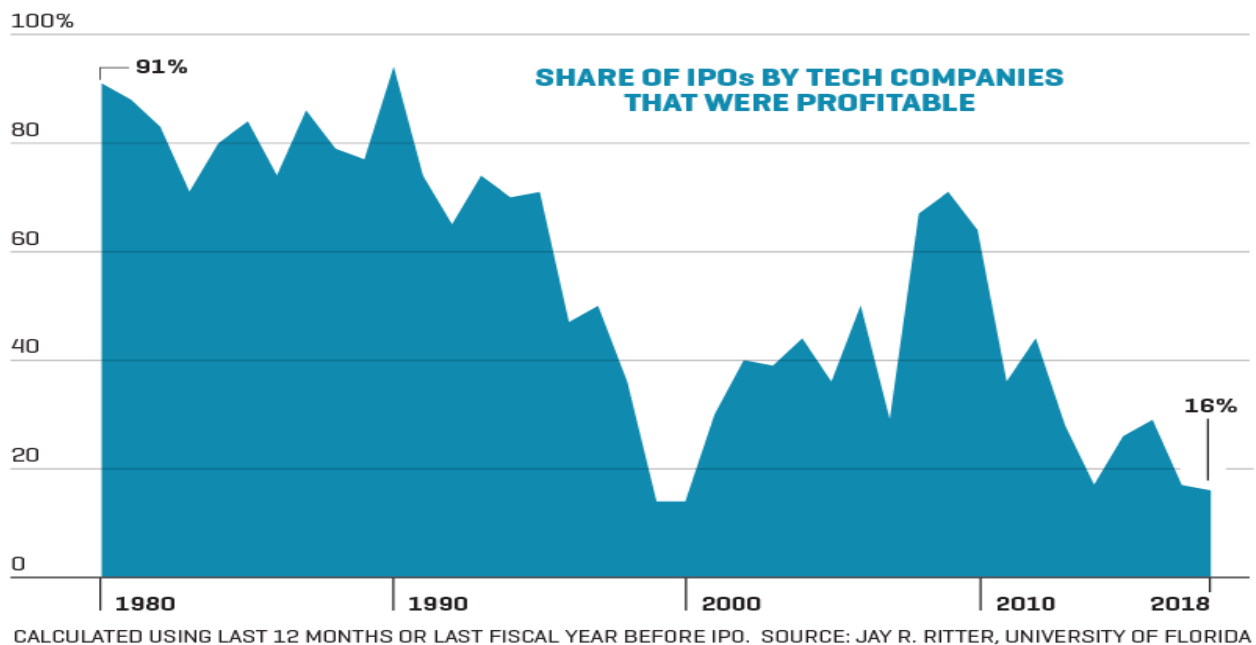
Recurring themes as described below abound:

- This time is different
- The next 10 years will closely resemble the previous 10
- Time-tested, traditional valuation metrics like price-to-earnings ratios and free cash flow generation are viewed with indifference
- New valuation metrics and buzz words like 'Total Addressable Market' are put forth as the new measuring sticks
- High profile IPO's and heavy insider selling from the most popular names

The chart below is striking to us. The biggest U.S. Initial Public Offerings (IPOs) and best performers are generating incredible operating losses:



If that weren't scary or mystifying enough, one needs only a superficial knowledge of history to make the connection between the incredibly high level of profitless IPOs at present and historically 'what happens next'. It is important, at moments in time such as this, to stop and think about one of the actual market mechanisms an IPO provides. The founders, private equity, and other early investors are turning to the public markets with the very real effect of being able to cash out. The late investors, anxious to get in on the next big thing, are the ones that get stuck holding the bag.



History has repeatedly shown us that investing late in a market cycle while using the thematic criteria described previously is a recipe for disaster and potential financial ruin. Again, we wonder how it is that so soon after the internet craze of the late 90's that we could be at this place. Our general observations on this phenomenon are as follows:

- A large swath of Millennials is now in important roles as investment decision-makers. This group of people has grown up in a stock market that has annualized over 15% per year for 10 years and has been accompanied by incredible change driven by technology. Should it surprise anyone that the possibility exists that they possess a muted sense of the risks inherent in investing?
- Many of the older, wiser investors whom we have followed and admired for many years are now retiring or closing their firms. This group has generally demonstrated wonderful long-term returns and has understood risk and return very clearly through many market cycles, yet they are viewed as out-of-touch. Their absence leaves a void of reason and perspective that is sorely missed.
- Other managers, seeing assets flee and envious of the success of other firms, start characterizing the popular investments of the day (the ones that are going up and widely owned) as fitting their pre-existing investment criteria but through new metrics. They essentially convert a value strategy to a growth strategy while still claiming they haven't changed their stripes.
- The 'buyers of last resort' have gone away. Typically before a security got too cheap, a long line of value managers was there to happily step in and buy at prices well below their fair value. As value has been out of favor for over 10 years (and these purchases have not resulted in market-beating returns), many managers are simply fatigued by the whole ordeal and have stopped investing in the areas that historically provided most of their profits.
- Algorithmic and passive investing has created gross pricing distortions in the general stock market. This has forced buying and selling of stocks based on factors such as their inclusion or exclusion in an index, recent price movements, certain company characteristics being favored over others, etc. The missing ingredient in it all seems to be any consideration regarding valuation or the price being paid for the actual asset.

It's been incredibly tough to stay the course for long periods of time while our investment approach underperforms the market in a relative sense. But as long-term investors we've seen markets like this one before. Our portfolio is designed and expected to create wealth not week-to-week or month-to-month but over many years. I personally have never seen so many cheap stocks in various industries hiding in plain sight. Our current portfolio and the plethora of opportunities presenting themselves on a regular basis lead us to believe that now might be the best time we have ever seen for value investing.

While we have confidence in the intrinsic values we have calculated for the securities we own, we don't know when the market might recognize the value we see and reward us via much

higher share prices. We had heard the sentiment expressed a number of years ago that perhaps the excesses in this market evident in eCommerce, anything cloud-based, and innovators, for example, will ultimately deflate with a whimper and not a bang as in the past. We believed then, as we do now, there might be some merit to this line of thinking. In previous market cycles the Fed, via their manipulation of interest rates, has been the maestro that has both inflated and deflated bubbles along with influencing the economic cycles by running at times too hot and other times too cold. What has been different the last 10 years, and looks to be continuing in the future, is that monetary policy has been too loose, and for far longer, than ever before. The result is that the natural price discovery mechanism for valuing securities has been absent for many, many years. The life cycle of money-losing startups has stretched on for a decade in some cases. In this Alice and Wonderland world of perpetual easy money, there is no need for profits just revenue growth and big ideas on things like how to colonize Mars, fly us around in autonomous air taxis, provide rentable scooters, and give us meat that is not really meat but rather made from plants. Here are some musings on the ‘life changing’ events of the recent past that have been afforded what we think are ridiculous valuations:

- Uber and Lyft. I love Uber / Lyft but aren’t they just really taxi services with a cool app? It seems the only way they will be able to make money is to raise prices. What happens if ridership decreases after the price increases take effect – which is exactly what has happened to Uber and Lyft in New York City – and the market then realizes they may never be profitable? Uber and Lyft have lost billions and neither has a discernable path to profitability any time soon.
- Wayfair. Are we as a society better off by being able to buy cheap furniture from an incredible selection with next-day delivery from Wayfair at the expense of local retailers? If Wayfair was doing so at a profit one might rightly argue that this is capitalism at its best. But the problem is that Wayfair doesn’t make any money. Below lists their net income as reported on Bloomberg every year since 2015:

2015	Loss of \$79.4 million
2016	Loss of \$194.4 million
2017	Loss of \$244.6 million
2018	Loss of \$504.1 million
2019E	Loss of \$645.6 million

Wayfair’s sales have increased from \$2.2 billion to \$8 billion over that same timeframe and their stock has gone up 635% on a cumulative basis. Yet, they expect losses to continue for the foreseeable future and have been issuing debt to fund their business the last few years. When local stores close communities and workers are deeply affected. The loss of income by the employees moves income away from their localities and relocates it to the headquarters of internet-based firms like Wayfair. Wayfair’s executives are heavily compensated with stock (they can’t share in the cash profits as there aren’t any) and they get rich while local communities suffer. It seems this isn’t a fair game being played and the root cause is easy or loose monetary policy.

- Tesla. We just don't understand it. We concede the fact from those we have talked to that it is a wonderful car to drive. What we don't get is how this company (or any company) could be allowed by the market to generate staggering losses for so many years. Again, this seems to be an affront to capitalism. We applaud the broad awareness of the need to be environmentally conscious. However, the idea that a Tesla (and really any electric car) is environmentally friendly seems crazy at the surface. There was a piece this summer in the Wall Street Journal on this very topic. The writer, Mark Mills, from the Manhattan Institute, wrote, "A single electric-car battery weighs about 1,000 pounds. Fabricating one requires digging up, moving and processing more than 500,000 pounds of raw materials somewhere on the planet. The alternative? Use gasoline and extract one-tenth as much total tonnage to deliver the same number of vehicle-miles over the battery's seven-year life." An additional consideration is the toxicity and disposition of the battery at the end of its useful life. In a world with more a classical risk / reward framework how long would this company have been afforded life?

I mention these (and there are many more) because we believe they are examples of companies with massive dislocations between their stock price and the economic profits they should reasonably be expected to generate. The interest rate policy of the Fed seems largely to blame. We are paying close attention to the potential day of reckoning for a large swath of companies that we believe could have stock prices correct not 20-30% but 80-90% or more when all is said and done.

Lastly, the idea that low interest rates, low inflation, moderate economic growth, low default rates for bonds, and super-charged growth for all things tech can continue ad nauseum seems like a crazy construct to us based on our knowledge of the past history of markets, economics and politics. But, as Hegel once said, "We learn from history that we don't learn from history."

We have identified a few things that could derail the current market:

Decreased tolerance for risk: Investors were very focused on whether the Fed would cut rates by 25 or 50bps in late July. It seems to us that a much more important market to handicap is whether the US corporate sector will stop gearing up and start running for cash; taking liquidity out of the system faster than the Fed can put it in. If this happens the tolerance for cash burning start-ups will likely see deterioration in demand. That would likely take liquidity out of the system more quickly than the Fed could push it in, putting downward pressure on risk markets going into 2020 and inducing many more Fed rate cuts after July.

Deceleration in hyper revenue growth: When growth stories disappoint it's not a pretty sight. As we look back, it becomes clear that early in 2017 something happened in this bull market. A large basket of stocks with hyper revenue growth but little or no profits started a rapid ascent in price. The prices reached valuation metrics similar or even beyond the absurdity we saw in the late 90's. But what happens to those stocks when growth disappoints? This is a chart of the company 2U Inc., which provides online educational services. The company has shown

exponential revenue growth since 2015 going from \$150 million in sales to almost \$600 million expected for 2019. Unfortunately, as with so many of these companies, that sales growth has come with a substantial increase in losses. 2U has \$13.4 million in free cash flow losses in 2015 and is expected to lose almost \$150 million in free cash flow in 2019. The stock was priced around \$16 per share in early 2016, exploded up to almost \$100 per share in the summer of '18 and has trended down ever since. The current price of \$13-14 per share sits below the price before its rapid ascent. This is typical of the price action that we expect to occur when a bubble bursts.



Firm Update

We are pleased to announce that we have been approved as a Separate Account Manager on Fidelity's Separate Account Network, one of the largest investment platforms in the U.S. This is a substantial and positive development for our firm.

Additionally, if you know of anyone who might be interested in our long-term, value oriented strategy we would welcome the introduction. For all prospective client partners, it is critically important they understand that our ability to preserve and compound capital is built on patience and discipline. We place a heavy emphasis on making sure the client partners we do business with are aligned with the firm's long-term strategic goals.

Please feel free to contact members of our team with any comments, questions or potential investment ideas.

Best Regards,

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