



Q1 2020 Masonry All Cap Select Commentary

April 2020

"The virus should go, but stimulative measures will likely stay."

Marko Kolanovic, JPMorgan Chase

To Our Client Partners:

The aim of our quarterly updates is to provide insight into the current portfolio and how we are positioned going forward. Please reach out with any questions or comments you may have after reading the letter.

Overview of the Portfolio

As of March 31, 2020 we were approximately 85.5% in equities and 14.50% was in a combination of cash and fixed income. The largest exposures at the end of the quarter were the common stocks of ViacomCBS, Anheuser-Busch and Gaia. The largest positive contributors to performance for the quarter were Gaia, Anheuser-Busch and Equitable Holdings. The largest negative contributors were ViacomCBS, DISH Network and Liberty Latin America.

Portfolio Highlights

We have excerpted the following from our Mid-March 2020 memo and 'filled in the blanks' in the *Portfolio Details* section to provide a more in-depth look at our portfolio activity during the recent market turmoil. As John Maynard Keynes once said, 'When the facts change, I change my mind.' We take the same approach to investing and the facts have changed in a drastic way. Economic and financial market events related to COVID-19 have caused us to re-evaluate each holding and search for ways to protect the portfolio but also to look for new opportunities given the extreme price movements. The following is a synopsis of our activity with regard to managing the portfolio through turbulent times:

- *Taking advantage of the opportunity to buy the securities of companies that have been on our wish list if they were offered at the right price – it is necessary to take a long-term view when making these purchases.*

- *Adding to current positions at deeply discounted prices.* These are businesses with which we are intimately familiar and have confidence in our calculation of the present value of their future cash flows even in the face of adverse current developments.
- *Exploration of areas of the financial markets that are in crisis or distress as this is where opportunities tend to present themselves.*
- *Portfolio adjustments are made to decrease risk in areas that are most exposed to the acute nature of the economic stress (i.e. banks in the 2009-2009 Financial Crisis).*
- *Reducing overall risk in the portfolio until such time that we are comfortable that we have developed a deep understanding of what faces us and the potential range of outcomes.* This includes holding more cash than is typical as well as putting on hedges (securities that rise in price when the market falls).

Portfolio Details

Hedging and Increased Cash Position

As COVID-19 began its journey around the world it became clear to us that the economic impact would be substantial (see March 2, 2020 Memo) but unquantifiable, at least in the near term. Given this, we took what we believed to be the prudent course of action by raising cash and purchasing securities that would rise when the markets fell (inverse ETFs). The securities that were sold either partially or in full were positions that we judged to be most at risk from the coming uncertainty. For example, an important component of the bull thesis for one of our long-time holdings, Viasat, was its position as an industry leader in Inflight Wi-Fi. With travel restrictions becoming tighter and tighter and with no clear end in sight, the risk became elevated and the upside impaired in our view. As a result, we trimmed the position substantially before selling it out entirely in the first quarter.

As a result of selling positions that we believed to be most at risk of a lengthy or even permanent impairment, the cash and fixed income position increased substantially to end Q1 2020 at approximately 14.5%. This gave us both a safe haven as well as dry powder to be prudently used as the smoke generated by COVID-19 clears in the months and years ahead.

Shipping Basket

The year started with a deep and broad sell-off of shipping stocks in tandem with the decline in the price of oil. This was a reaction to the potential slowdown in global growth due to the spread of COVID-19. After an in-depth review of our original thesis (outlined in our past letters), we came to believe our shipping investments might actually benefit greatly from the coming glut in oil. In a unique twist, as global oil demand was falling off a cliff, OPEC+ decided to increase production. Many believe this was an attempt to put the U.S. shale companies out of business and re-establish the dominance of foreign producers. This resulted in the futures price

of oil being higher than the spot price which is known as cantango. Functionally, the cantango trade consists of buying oil at today's price, selling it at the futures price and storing it (ships are used as a place of storage) until delivery. This trade is even better when interest rates are low and, with the Fed quickly reducing rates to zero during Q1 2020, it became a very profitable endeavor. The longer the imbalance of supply and demand for oil persists the better it is for our basket of shippers. In fact, many could earn the annualized equivalent of close to their entire market caps if cantango lasts through the remainder of the second quarter.

Content and Media

What we believed to be incredibly inexpensive share prices got even cheaper during the recent sell-off. Out of an abundance of caution we have scaled back our exposure to these names but remain confident in their ability to weather the current environment and rebound in substantial fashion. The trading levels of these securities are absurdly cheap but not out of character with where they (or some derivation of their present selves) have traded in past recessions. The bad news is share price corrections that usually occur during recessions due to ad revenue uncertainty happened in the span of a month. The good news is that when looking through past recessions to the recovery period, the returns of these stocks have been substantial when revenue and earnings increase and multiple expansion occurs.

Opportunistic Purchases within Q1 2020

We took advantage of severe price contractions to purchase a variety of securities during March. The portfolio added positions in the common stocks of Anheuser-Busch Inbev (Core), Equitable Holdings (Special Situations), DHT Holdings (Special Situations), Berkshire Hathaway (Core) and Dollar Tree (Core). Importantly, we established starter positions in each instead of full positions choosing to wade into the water instead of just diving into the deep end. Although each investment was made on the company's individual merit, the commonality was an extremely discounted share price. The position sizes of each are commensurate with our assessment of the risk each face as well as the presence of a catalyst that should speed the revaluation to our estimate of fair value.

Market Thoughts and Observations

It seems the competing argument in the market at present is whether or not the economy will experience a V-shaped or U-shaped recovery coming out of the COVID-19 crisis. We admit we have no particular insight that qualifies us to be an authority on a subject which really has no historical precedent. However, we do believe it is unlikely that we will bounce-back quickly to pre-recession norms in short order. Historically, recessions, regardless of how they begin, leave scars that take time to heal. To date, their presence has marked the end of the business credit cycle. Corporate leverage and speculative investments need to re-adjust to a more normalized level. As this process unfolds, tremendous opportunities are almost always presented.

At the beginning of this year many stocks in the portfolio began trading as if we were already in a recession. When the dot-com bubble burst, value stocks began to significantly outperform growth stocks prior to the economy rolling over into a recession and for many years after. In direct contrast this time around, value stocks have suffered pre-recession while the high-flying story stocks have stayed aloft and remain, in our opinion, massively overvalued. If we experience a deep recession and a gradual recovery how will stocks priced for rapid growth react? Our guess is not well. Slow growth is like kryptonite to these types of stocks particularly at nosebleed valuations. This makes it highly likely in our opinion that we may experience something akin to the post dot-com shift in market leadership but this time around the bursting of the bubble comes after the recession and not before.

Perhaps the craziest thing we have seen in our investing careers is that long duration equity plays (those companies with high revenue growth but little-to-no profits) have not yet received the memo that things have gotten much worse economically and may remain that way for quite some time. In fact, the response to Covid-19 has been to double down on the popular trade in place the last few years. Bear markets caused by recessions correct excesses and realign misallocations of capital. This simply hasn't happened yet in a large swath of stocks. Investors seem to view our current lockdown as temporary with limited long-term impacts but this is ignoring the significant credit impact, revenues lost forever and the 'going concern' statements soon to be reported for many money-losing businesses. Instead, for story stocks like Virgin Galactic (provides vacations in outer space) the market has continued to bid them up. This company is just one of many that fit into an almost unimaginable category. Peter Cecchini with Cantor Fitzgerald used Bloomberg data to find that there are over 200 'no revenue' or 'cash flow negative' public companies with market caps over a billion dollars.

Many investors also seem to believe that the past market leaders are great values because they have declined in price a bit from their peaks despite their still incredibly high multiples. This is decidedly first-level thinking. This view is held and traded upon in the complete absence of forthcoming financials for the remainder of 2020 and beyond.

For the Disruptor bubble (see Chart 1) to continue we are of the opinion that the combination of low interest rates, low inflation and low and slow economic growth (without a recession) needed to remain in place. Due to the COVID-19 crisis, a low interest rate environment is a necessity to keep the economy afloat but it should soon become clear that although inflation may remain low while demand is depressed, once demand picks up the supply chain most likely will not be able to keep up. Inflation should ensue. Also, for anyone paying attention, it should be obvious that the U.S. has entered into a recession. It is highly questionable that the bubble can continue absent the conditions we have laid out. If we are correct the day of reckoning will be at hand sooner than later.

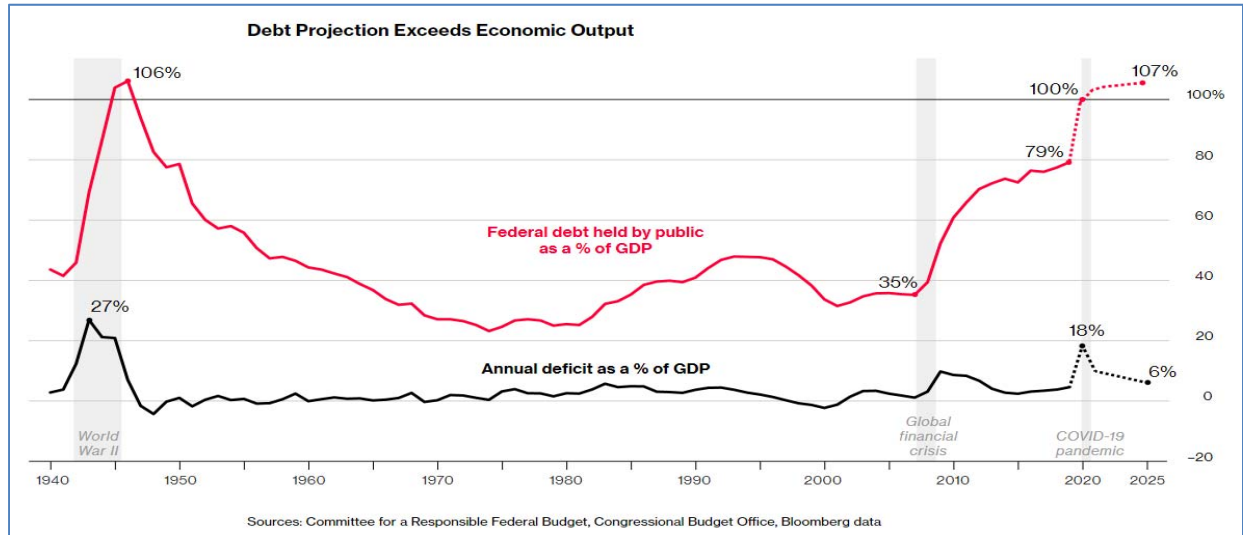
Chart 1



Investor preference could soon shift from ‘who can grow revenues the fastest’ to ‘who can survive’ in a downturn. When that occurs our portfolio should benefit greatly. Importantly, there is precedent that leads us further down the path of believing the extreme divergence between our incredibly inexpensive portfolio and insanely expensive stocks will converge over time. We have written about this before but it bears repeating that every decade is different. Past market leadership doesn’t portend well for future market leadership. ***We have chosen the path of constructing a portfolio of incredibly inexpensive, out-of-favor companies that generate profits where the risk reward is highly favorable and the potential investment returns are substantial. This is not our first rodeo. We have followed this script in the past and the results have been proven to be well worth the short-term pain.***

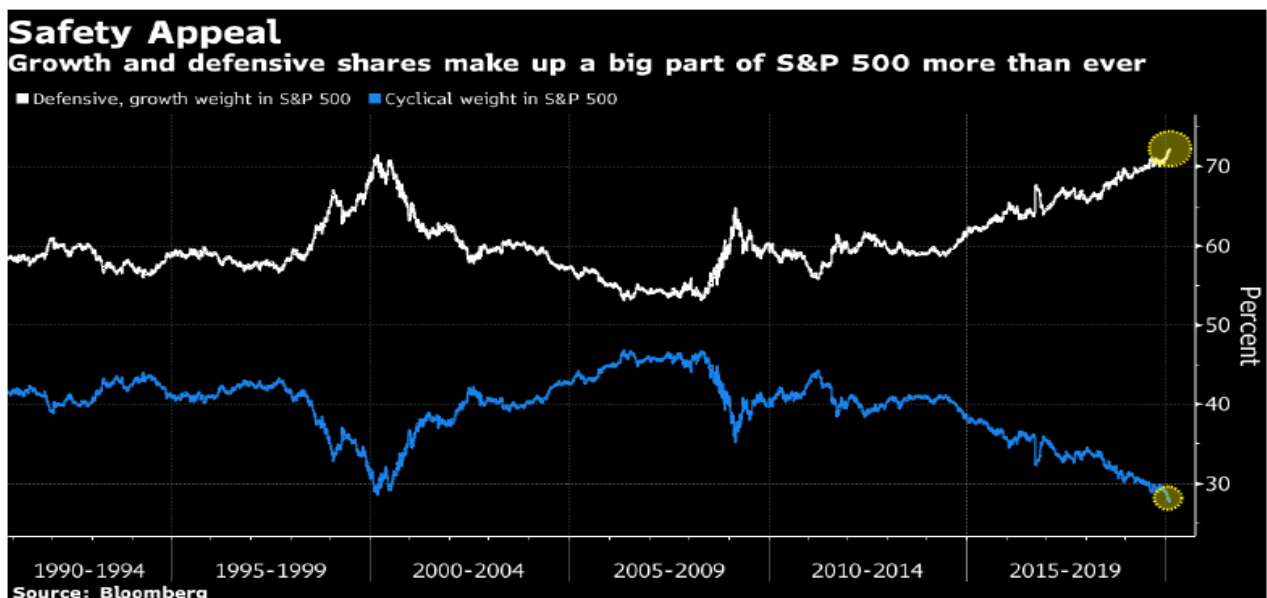
The recent fiscal and monetary stimulus has been breath-taking and provided, at least temporarily, a floor to both the stock and bond markets. We believe that this represents a game-changing event with regard to future market leadership. It is likely that the U.S. will follow the play book from the WWII era with regard to interest rates and inflation. As our current levels of federal debt as a percentage of GDP approach that of WWII, we are faced with a set of unseemly outcomes; default or debasement. We chose debasement before and we believe we will again. The simple formula is to keep interest rates low through interest rate caps (the long-term US Treasury was capped at 2.5% in WWII) and let inflation run high (10%+). We would venture to guess inflation will most likely not see the levels hit in the 1970’s but rather a band of 6-10% over a long period of time (maybe a decade or more) which should do the trick. This is a very stealthy, but effective way to ‘pay back’ debt (see Chart 2).

Chart 2



It would not surprise us at all if COVID-19 proves to be the ultimate catalyst of a leadership change in the markets. With Cyclical stocks at the lowest level ever as a percent of the S&P 500 and Growth and Defensive stocks at their highest weighting (Chart 3), market forces are now at work which should reverse this dynamic in future years. For instance, it's been said the cure for low oil prices are low oil prices. Imagine a scenario where current production cuts in oil become unexpectedly permanent due to bankruptcies or wells that can't be reopened after being closed just as supply starts to more closely match the reduced demand of the world economy. What happens then when aggregate demand starts to pick up at about that same time as the oil supply is retarded? After all, it is simply a supply and demand equation – and if it is imbalanced in the way we described, it will lead to higher oil prices and probably higher inflation than we have seen in many, many years.

Chart 3



Firm Update

We can't stress this enough, we believe the opportunity at hand is extraordinary – we own a portfolio of securities that are as deeply discounted from our estimates of fair value as we have ever experienced - particularly when looking out over the next 3-5 years. It would be nice if the value we see in our holdings was reflected in their respective share prices in the immediate term but, unfortunately, that is not usually how it works. We are patient investors and are very appreciative of the fact that our partners are patient too.

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

Best Regards,

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