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Separate Account Partner Letter
March 2020

Dear Client,

We write during this time of unprecedented volatility in financial markets. As you're aware, the Coronavirus pandemic has wreaked havoc on the prices of marketable securities, sending the S&P 500 plunging 34% from its peak over only 23 trading sessions through Monday, March 23rd, a historic selloff in terms of both size and speed. While circumstances are improving, fear and volatility prevail at record levels and remain elevated.

We view ourselves as long-term owners of businesses and believe this period represents a unique and exceptional opportunity for the investor. We've always set the expectation that significant volatility would eventually return to the markets with a vengeance, without attempting to forecast its timing or nature. With the storm now upon us, it is important to execute upon our long-term plan, adhering to our ownership-oriented philosophy, to maximize this long-awaited opportunity.

The United States, along with much of the world, is currently under lockdown to slow the spread of the virus. Many businesses have been forced closed by the government, with a question as to when or if they will reopen. Unemployment is poised to spike, supply chains are fragile, and entire industries appear on the brink of failure. It goes without saying, but we will say it anyway: the implications for investors are significant.

We are confident that this too shall pass. Significant government intervention is forthcoming to combat this public health crisis. The Federal Reserve has undertaken unprecedented measures to infuse the financial markets with liquidity and financial market participants with confidence. Both the executive and legislative branches are adopting a whatever-it-takes approach to backstop the economy.

As governments are mandating the current cessation of economic activity around the world, so too will governments bear many of the corresponding costs incurred. Data from international counterparts regarding the virus is finally improving, with sovereign governments undertaking their own interventionist measures.

We believe the American economic system will survive and flourish. While significant challenges remain ahead, we believe: market panic and indiscriminate selling has created exceptional bargains in certain high quality businesses; fiscal and monetary stimulus are critical to the economy's recovery, and the Federal Reserve and Treasury have acted swiftly and appropriately; and lower interest rates, possibly now "lower for longer" as a result of this unprecedented stimulus, may continue to provide a long-term tailwind to equity investments.

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We're all reading the same headlines, but how one reacts to these headlines will largely determine one's investment success or failure. It is essential to remember that a price quotation for a common stock merely indicates where current supply meets demand at a moment in time, often determined by emotions such as fear and greed, and not rational thinking. Volatility exists to serve you, not to guide you.

We understand that recent volatility can be gut-wrenching, testing even the most experienced investor. Investing appears easy when markets seemingly rise every day, as they have over the past decade. Complacency born in the roaring bull market of the last 12 years, wherein volatility was virtually non-existent, exacerbates the current shock felt by many market participants.

It is in trying times of precipitous market decline that following the core tenets of value investing matters the most. We believe that it's particularly important to reinforce these foundational principles in times of distress:

1. **Volatility is a fundamental part of the investment process.** Volatility is not risk, but a friend to the buyer with a value orientation. We define risk as the possibility of permanent capital loss, not the degree by which a security's price fluctuates.

Equities, which can be readily purchased or sold, are inherently volatile, regularly changing in price far more than the underlying business values that they represent. Even in stable times, share prices of the most liquid and widely-held companies can swing over 100% over a year or less. The long-term value of a business, on the other hand, generally does not change much on a short-term basis.

2. **Invest with a long-term time horizon**. The way to manage such inherent volatility is to assume a long-term time horizon, which we define as a minimum of three but ideally more than five years. Investors should not invest in stocks if they may need the money in the short-term, as one of the most costly mistakes in investing is being forced to take a permanent capital loss, selling during a market decline, to meet short-term cash needs.

It is impossible to consistently time the market. We know no one who has done so. History shows that durable, conservatively financed businesses will, in the context of a portfolio, emerge better positioned and thrive following difficult economic environments. By assuming a long-term approach, investors are able to stick with their convictions in times of heightened uncertainty, able to stay the course amidst pervasive volatility and seemingly incessant bad news and despair. ***Employing a long-term time horizon, coupled with the ability to control one's emotions in times of duress, is perhaps the most significant competitive edge in investing.***

3. **Invest with a fundamental, value-based approach**. It is important to adopt an absolute-return approach, investing based on the economics of businesses and their future prospects. "***Value investors are interested in returns only insofar as they relate to the achievement of their own investment goals, not how they compare with how the overall market or other investors are faring.***"[1] This means ignoring index results and not chasing investment fads, incurring unnecessary risk.

We continue to invest on a bottoms-up, fundamental basis, with a return target that offers an attractive return to one we could earn without incurring any risk, the 10 year Treasury bond. While there is no precise number, we believe earning a high single digit return over the 10 year Treasury bond yield is a satisfactory return.

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We are investment partners. Your primary responsibilities are to uphold tenets one and two, embracing volatility and investing on a long-term basis, which become most important in trying times. We are primarily responsible for guiding and ensuring your commitments to these tenets, especially in times of uncertainty, and to remain steadfast to tenet three, investing with a value framework, in managing your portfolio. We take this opportunity to highlight our investment framework, referring to moat, management, and margin of safety ("MMM"), which we employ to select those quality businesses able to withstand even the most significant business disruptions.

<u>Moat</u> refers to the resiliency and durability of a business. Like a moat around a castle, a moat represents a business' ability to maintain its competitive position in the marketplace, warding off competitors, enduring technological change or other threats. A moat is often reflected by high returns on capital, significant reinvestment opportunities, a small number of competitors, or other enduring competitive advantages, such as being a low cost producer or selling a product or service that possesses significant pricing power.

<u>Management</u> refers to talented and honest management teams. We seek to invest alongside leading operational managers, as well as superior capital allocators, demonstrated by investment discipline and sound judgment, often evidenced by high return-on-investment policies.

<u>Margin of Safety</u> refers to the disparity between the price at which an interest in a business can be purchased and the underlying value of the business. If a company has a strong moat and management team, but is not available for purchase at an attractive price, it is not an attractive investment. There are many great companies that are often poor investments.

Through owning a collection of interests in durable, high quality businesses run by exceptional management teams, ***purchased at prices significantly below their long-term intrinsic values***, our portfolio is constructed to weather even the most severe economic storms. Businesses are consistently faced with competition

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[1] Klarman, Seth A. (1991) *Margin of Safety, Risk-Averse Value Investing Strategies for the Thoughtful Investor*. New York: HarperBusiness.

and economic uncertainties, and those that are durable and conservatively financed, with leading managers, will adapt accordingly. The ability for a business to service its obligations through prolonged business disruption, in a manner not significantly impairing shareholder value, is the ultimate gauge of durability. ***In times like these, the importance of knowing what you own and thinking like an owner becomes readily apparent.***

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News headlines may worsen in the coming months. However, individual investment bargains are likely to have bottomed well before the bad news disappears. It is impossible to perfectly catch a market bottom, and the market may continue to decline in the short-term. We believe this is almost always not a sufficient justification to abstain from investing. ***The rational way to invest is to seize upon individual opportunities when value can be accessed cheaply***.

While concerns surrounding the Coronavirus and its implications on business activity are well founded, we believe the reaction to those concerns has become exaggerated, with many stocks falling more than 50% from levels reached only weeks ago. ***Often more than 90-95% of the value of a business is based on the cash flows earned beyond one year; in fact, the majority of the value of large publicly traded businesses as a whole resides in the cash flows they generate more than a decade into the future.*** While business conditions have changed, the underlying values of durable, high quality companies have not changed substantially. It is this disparity—the ability to identify a significant difference between the price of a business and its underlying value—which defines an investment opportunity.

The value investor eagerly approaches such volatile investment environments, realizing the opportunity to increase holdings at deeply discounted prices, or rebalance portfolios into even more attractive investment opportunities. The real-time price quotes of current holdings are understood to be largely irrelevant in the longer-term context. A high quality business' investment merit is inversely related to the valuation at which it trades. High quality businesses trading at low valuations is the stuff dreams are made of.

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We view this as an exceptional opportunity for the buyer of long-term business values. We don't attempt to forecast the next year or two, but are confident that American business will pull through this tumultuous period. While we can't predict the timing, we're confident in the outcome. Our portfolios, as well as newly identified opportunities, are comprised of interests in resilient, high quality businesses, which we believe are poised to emerge from this crisis well positioned, growing stronger.

To the extent that you have additional investable cash available, or other accounts to consider rebalancing, please let us know. To reiterate: we define investable cash as funds that you do not expect to need to access for a minimum of three and ideally five years.

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We'd like to end this note by saying thank you. Thank you for providing us perhaps the most significant competitive advantage that we can ask for as your adviser: your trust, support, and patience. We view this as the golden goose to superior long-term investment results. It is your long-term orientation, adhering to the core tenets of sound investing during these tumultuous times, when it matters most, which allows us to together achieve successful long-term results.

Despite the historic recent market volatility, we have not heard from virtually any of you. Unlike other advisers who have had to spend their past few weeks repeatedly talking down panicking clients from the proverbial ledge, reiterating important principles set forth at the onset of the relationship, our time has been allocated to where it is most valuable, monitoring your portfolio and improving it where possible.

Should you have any questions, or if you would like to discuss this letter or just say hello, please don’t hesitate to write or call.

Sincerely,

Sophis Investments

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Rational Investors invests primarily in two types of equities, which we refer to as "Generals" and "Special Situations":

General — A generally undervalued security where we have nothing to say about corporate policies and no timetable as to when the undervaluation may correct itself. It is difficult at the time of purchase to know any compelling reason why the security should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, it is available at very cheap prices, creating a comfortable margin of safety in each transaction.

Special Situation — A security whose financial results depend on corporate action rather than supply and demand factors created by buyers and sellers of securities. In other words, these are securities with a timetable where we can predict, within reasonable error limits, when we will get how much and what might upset the applecart. Corporate events such as a consolidation, liquidation, proxy contest, spin-off, bankruptcy, death of a control person, large share repurchase or litigation lead to special situations.

Within the above two categories, we narrow focus to emphasize what we refer to as "Super Investors", "Buybacks" & "Spinoffs":

Super Investors — These are companies that are owned by one or more "Super Investors," which consist of a limited number of investors who have been able to provide above average investment returns over a long timeframe.

Buybacks — These are companies that have effected a significant net reduction in shares outstanding, or are expected to significantly reduce shares outstanding.

Spinoff — These are companies that have been involved in a spinoff transaction, which occurs when a company takes a subsidiary, division, or part of its business and separates it from the parent company by creating a new, independent company.

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