Lugarno Fund

INVESTOR LETTER
30 September 2020

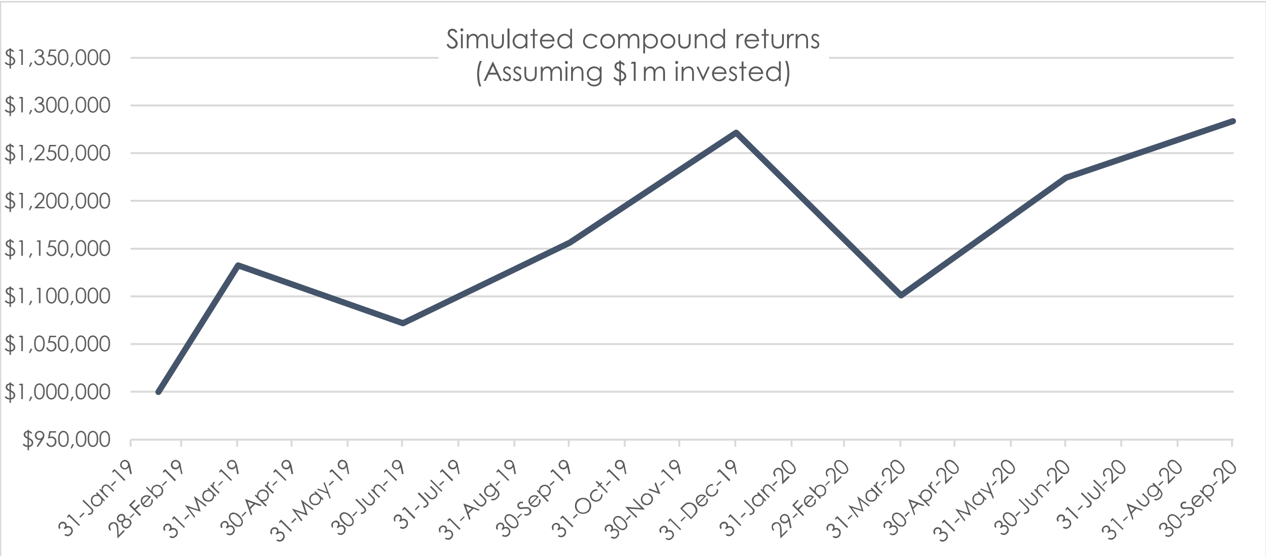
13 October 2020

Dear Partners,

The returns for the Lugarno Fund as at 30 September 2020 are as follows:

3 months	12 months	Since inception (15 Feb 2019 / 19.5 months)
+4.85%	**+11.02%**	**+28.37%**

The fund began on 15 Feb 2019. Since inception it has provided a return of 28.37% (after all fees and costs). In other words, if you had invested $1m in the Lugarno fund at inception, it would now be worth $1,283,736.



"Only when the tide goes out do you discover who has been swimming naked" - Warren Buffett

COMMENTS

The portfolio continued to increase in value post the depths of the COVID sell-off. While it is nice to see that the contrarian decision making we made has had a short-term pay off, our benchmark for success is much higher and we expect to achieve it over a much longer a period than 18 months.

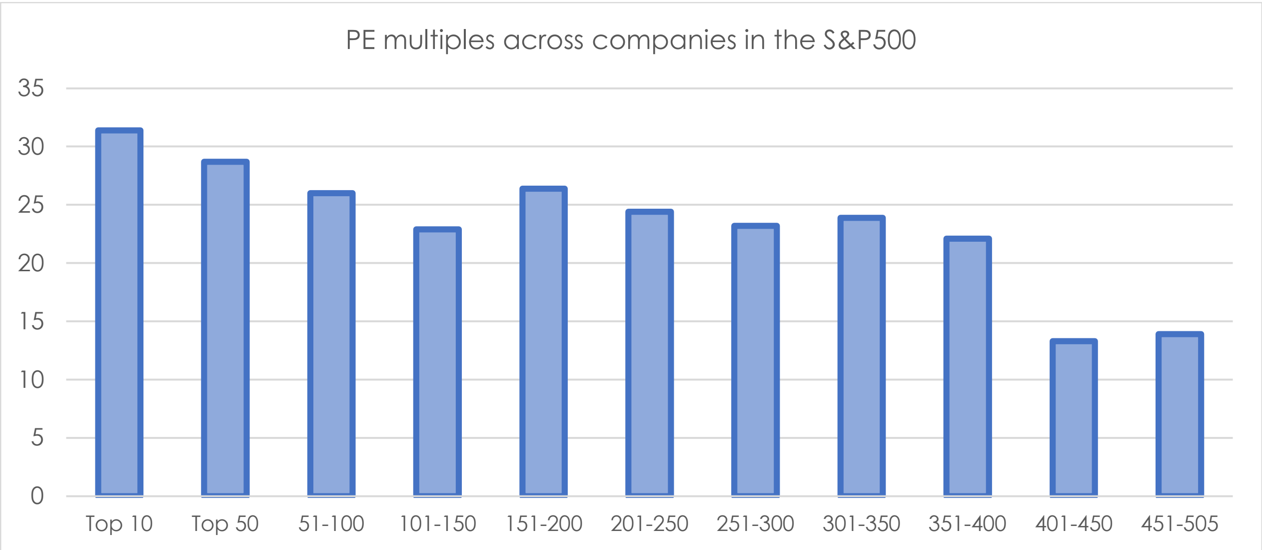
At the time of writing this, the portfolio had 2.5% in cash and 4.5% in Gold and Silver. The balance of the portfolio consists of 17 investments which we believe are worth a lot more than their carrying value.

You may note we have invested most of the spare cash (and some Silver). We believe that the investments we have made are worth at least what we paid for them even under some very negative outcomes. We are optimistic about the funds returns over our time frame of 3-5 years.

As this document goes to a wide audience, we have been reluctant to disclose information regarding our underlying investments. We have recently sent invites to our investors for a **video call we are hosting on Tuesday 27 October at 10.30am** (NSW time) where we talk more candidly about our large investments. If you are legitimately interested to invest in the Lugarno Fund, do not hesitate to reach out to me for an exclusive invitation.

The market: is not what it seems

The fact we have been investing the cash should be considered a reflection of our optimism in the underlying businesses we have identified - certainly not in the market overall. While the stock market valuation on an overall basis looks high, not all stocks are expensive. The table below shows that value is on offer outside of the larger (tech) companies within the S&P500.



It is a well held belief that smaller companies are riskier therefore warrant a lower multiple (as above). However, during the past 12months profitable companies like Schlumberger and Southwest Airlines dropped down the ranks while unprofitable companies like Zoom and Snap (chat) moved up.

Despite the hype, a payments company has a much more uncertain future than Southwest Airlines. While we share the view these new tech businesses 'could' have a bright, we think the market is mis-pricing the uncertainty in that assumption.

Anecdotally, we are finding profitable companies being left behind in the market's obsession with new and shiny; ones where the downside appears very small but the potential rewards very large. We are investing in these opportunities and are optimistic about our returns from them.

Value investors performed very well throughout the tech stock market crash in 2000. Given the similarities between this market and the late 90s, we think that could well be repeated when the tide eventually goes out.

Our investment approach is to purchase companies at large discounts to our assessment of their intrinsic value. The 'discount' is essential as it allows us to profit even in a scenario where the business or market does not progress as planned.

Market anecdotes

As students of investing, this is a very fascinating period for us. The stock market (in the short run) is largely driven by the collection of investors emotions. Like any other public gathering, we see the full range of consciousness. In this recent period, we are witnessing some of the craziest investor behaviour I have ever seen. Below is a collection of some examples.

- Tesla's fully diluted market cap is now $445bn. That is twice the value of Toyota ($202bn).
    - Tesla sold 367,200 cars last year and have never reported a profit
    - Toyota sold 10.46m vehicles and made $3.1bn in profit last year
    - Toyota produce Tesla's annual production capacity in just 7 days

- AfterPay's market cap is now more valuable than Cochlear (an Australian company with two thirds of the world's hearing implant market).
    - Cochlear last year generated $1.3bn in revenue, $270m in profit. They gave 31,662 people the ability to hear
    - AfterPay last year generated $450m in revenue, they lost $20m(they have never made a profit). They gave 9m people the ability to buy a t-shirt they couldn't afford
    - If I told you that AfterPay is also considered more valuable than Coles – but you probably wouldn't listen

- Nikola Trucks at one point was valued at $20bn. The company has no revenue and was recently caught out for a number of dubious claims. One being that its marketing video showed a truck speeding down a freeway. It was discovered later that the truck was rolling down a hill and wasn't actually able to move by itself.

- WeWork managed to last 9 years spending twice as much as they were making. Despite this, investors paid a valuation reaching $20bn before reality finally set in. While failing to create value for shareholders and cashing out along the way, the founder was awarded a $1.7bn on the way out.

Investing vs speculation

I am convinced that to invest successfully, rationality trumps intellect.

The investing game is overrun by smart people with impressive resumes who get lured in by the cash rewards on offer. The human tendency to gamble is a strong one, new participants chase the big and fast returns.

Just like the prelude to any other market collapse, speculators (read: gamblers) are often rewarded with the first few throws of the dice. The quick wins fuel the confidence and encourage riskier and larger bets.

Per the anecdotes above, this is one of the rare periods where speculation is rewarded. The level of retail participation is immense and is characterised by late cycle speculation. We have seen it all before.

The thing with speculation is that the music will one day stop, and you don't want to be left holding the bag. The big gains are quickly replaced by big losses which are very hard to recoup – especially in a different more rational market. I will take the small to medium sized gains any day if it means avoiding the big losses.

I've learned that in this game the best combination is a minimum level of intellect combined with rationality and humility. The dangerous combo is a highly intelligent person without their ego in check.

"Knowing the edge of your competency is important. If you think you know more than you do, you will get in trouble." - Warren Buffett

We have had some early wins in the fund, it feels good. Crucial to achieving our long-term goals, will be avoiding the hubris that usually comes with investment success. Li Lu says "Investing is like golf. You carry a similar process to each hole but they are independent. If you get a hole in one you can't get overexcited as it'll negatively impact the next one".

There is no complete cure for our monkey minds, but with some awareness and effort we are containing ours.

Simon Harradence
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THE FUND

We believe in the concept of skin in the game – we eat our own cooking.

This fund serves as the primary investment entity for my family's wealth so you can be confident we are treating your investment like it's our own.

This fund exists to generate solid returns and if we fail to do so we do not deserve to be in business. We do not charge a management fee and only earn performance fees if we achieve returns of greater than 6%. This fee structure is a clone of Warren Buffett's early partnership.

We believe that the easiest way to grow capital is to avoid losing it. In practice this means that investments require a large margin of safety between what we pay and the value we believe we are receiving. We also prefer companies with substantial tangible assets to protect us should things not go to plan.

Good investment opportunities are rare so when they come along, we are willing to invest significant amounts of the funds capital to maximise the investor's benefit. Conversely, we are content holding substantial cash in the absence of valuable opportunities.

In order to consistently make good decisions, we cultivate a sceptical and contrarian mindset. It is statistically impossible to generate great returns by investing with the same lens and conventional wisdom of 'Mr Market'.

Our investment strategy looks to capitalise on two main elements of the investment market place.

- Inefficient distribution of information: This is where under-researched companies are much less understood by the broader market
- Over-reaction tendency: This is where investors act in heard like behaviour by over-reacting to negative news on otherwise quality investments

Well known opinions are usually priced into stocks and so we find that ideas are only valuable if they are contrary to consensus.

Internally, we judge our performance over periods of at least 3 years and we ask you do the same. While we strive to identify near term catalysts for our investments, 'Mr Market' rarely agrees with our perspectives us as fast we would like.

We believe wealth gives people the freedom to live their best life and we are immensely proud to get to work every day helping you with that.

FUND PARTICULARS

Trustee	DDH Graham Limited
Investment Manager	Lugarno Partners Pty Limited
Administrator	DDH Graham Limited
Auditor	Findex
Min investment amount	$250,000
Min investment term	2 years
Redemptions	90 days notice
Ongoing fee	Zero management fee
Performance fee	Performance fee of 25% above a hurdle of 6% subject to a high watermark
Buy/sell spread	0.5% of applications and redemptions
Fund operating expenses	Capped as the higher of $50k or 0.5%

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This update contains information concerning about the Lugarno Fund (Fund), an unregistered managed investment scheme, and has been prepared by Lugarno Partners Pty Ltd ACN 607 035 138 AFSL no. 508934 (Investment Manager) as investment manager of the Fund. DDH Graham Limited ACN 010 639 219 AFSL no. 226319 (Trustee) is the trustee of the Fund. This update is for distribution only to wholesale clients as defined in section 761G of the Corporations Act and to sophisticated investors under section 761GA of the Corporations Act. It contains general information only and is not intended to provide advice to any particular investor, nor take into account an individual's investment objectives, circumstances or needs.

Returns shown are net of all fees and costs. Past performance is not indicative of future performance. This update also contains statements about the estimated future performance of the Fund, which are based on a number of assumptions that may not prove to be correct or appropriate. Actual performance may vary from estimated or forecast performance. Neither the Investment Manager nor the Trustee give any representation, assurance, guarantee or warranty that the estimated return or any projection, forecast or assumption contained in this document will actually occur.