Lugarno Fund

INVESTOR LETTER
30 September 2023

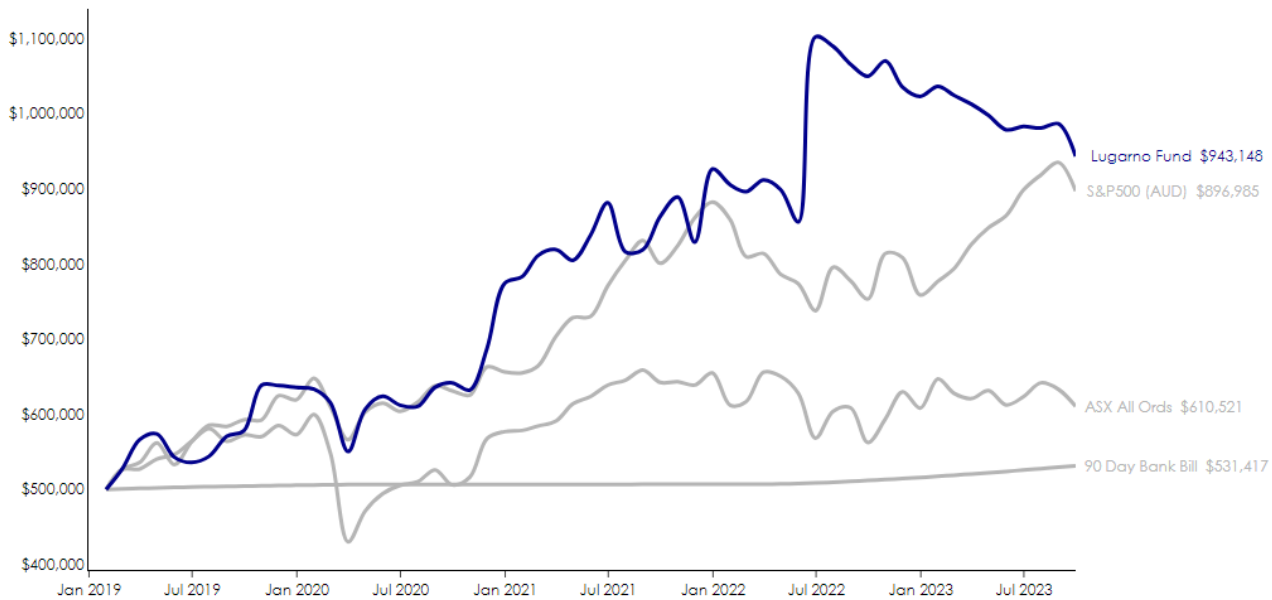
7 November 2023

Dear Partners,

The returns for the Lugarno Fund as at 30 September 2023 are as follows:

3 months	12 months	Since inception [15 Feb 2019]
-4.03%	**-10.14%**	**+15.63% pa**

Since its inception on 15 Feb 2019, the Lugarno Fund has delivered to investors a return of +15.63% pa (after all fees and costs). The chart below illustrates that $500k invested in the Lugarno Fund at inception would now be worth $943,143.



*ASX All Ords is accumulation (assumes dividends reinvested)

"You don't want to make money by screwing your investors and that's what a lot of venture capitals do" Charlie Munger

Protecting what hard work built.
02 5602 2060
lugarnopartners.com.au
PO Box 1997
Kingscliff NSW 2487
AFSL: 508 934
ABN: 72 607 035 138

PORTFOLIO

In this letter, you will find a greater amount of detail about our underlying investments. This letter only goes to existing investors (partners) in the fund and so I'd like it to be as useful as possible. The additional material is what I would want to see if the roles were reversed.

My goal is for this fund to extend out 30yrs and I want us all on the journey together. As with any portfolio aiming for above average returns, we will enjoy strong periods (like our first 3 years) and weak periods (like last year). It's part of my job to give you all the info you need to maintain confidence in your investment throughout all those periods.

At the time of writing this, the list of largest holdings (from largest to smallest) was as follows. Each position holds at least 5% of the portfolio and entire list makes up ~80% of the portfolio.

1. Litigation Capital Management (LCM)	5. Carconnect
2. Stratton Finance	6. Advanced Cosmeceuticals (AC)
3. Cash	7. Thryv Holdings
4. Aimia	8. Topicus

Litigation Capital Management held their AGM and a range of investor meetings which we attended. Cash flow has increased dramatically as the backlog of unresolved cases unwinds. Our investment thesis has the three key elements we look for…

a) Limited downside. Our estimates of liquidation value are nearly twice the current market value.
b) Significant (potential) upside. If LCM continue to earn even half their historical returns, we expect cash flows to be more than twice their current level in three years, and compound again at the same rate three years later.
c) Aligned management: The founder (Patrick) continues to lead the business. Patrick, the chair, and key staff collectively own more than 16%.

The holding in **Stratton Finance** is the remaining 30% that wasn't sold in FY22. This is being purchased in early 2024 and so will provide the portfolio with substantial cash.

Aimia had an action-packed quarter. They held their first investor day which gave us more transparency (and optimism) on their portfolio of companies. They also received a takeover offer which they declined. They also took on new board members (and investors) with an impressive reputation. The stock is selling for a large discount to our conservative (SOTP)* valuation. We are hopeful the new board will provide the much-needed focus and stability for shareholder returns.

*Sum of the Parts (SOTP) valuation is a process of valuing a company by determining what its aggregate divisions would be worth if they were spun off or acquired by another company.

Carconnect was spun out of Stratton before the sale at no additional cost to us. The car industry (inc. Carconnect) has experienced a tough two years and consequently been the primary cause of the fund's lower unit price. The business provides tremendous value for its customer. Now that costs have been reduced and the business is more focused, we are hopeful for their future.

New Investments. We have three new investments in our pipeline which fit within our criteria.

We have more details on the fund's underlying holdings which we are more than happy to share with you. If you have any questions, or, would like additional info, please reach out and we will gladly communicate.

GENERAL

I've been investing for clients for 10 years now. To make the next decade even better than the first, I've spent some months reviewing our decisions and looking for areas of improvement.

Perhaps unsurprisingly, our best investments were largely in line with our long-held criteria while our worst investments had some sort of conflict either before or during the investment period.

This begged the question, why do we make investments which (in retrospect) conflict with our own investment criteria?

"*It's not supposed to be easy. Anyone who finds it easy is stupid.*" Charlie Munger

I would expect most investors criteria to look similar ie. what makes a good business/a good investment is a universally agreed upon idea. Despite this, why do so many of us occasionally deploy money into opportunities which quite clearly conflict with our pre-determined values?

Daniel Kahneman shares a concept in his book 'Thinking fast and slow'. He defines two systems of the mind…

- System 1 (monkey mind): operates automatically and quickly, with little or no effort, and no sense of voluntary control,
- System 2: allocates attention to the effortful mental activities that demand it, including complex computations.

"The problem is to keep the monkey mind from running off into all kinds of thoughts" Lee Kuan Yew

What makes investing hard is that while being surrounded by a marketplace of System 1 influences, it is difficult to engage and make decisions using System 2. System 2 allows us to step through the myriad of variables rationally and be patient enough to wait for only those opportunities which fit neatly in our framework.

System 1 can't be turned off, yet a lazy or tired System 2 makes us prone to cognitive biases – the common causes of human misjudgement.

As you may expect, it turns out our investment criteria didn't need much changing at all. What needed improvement was a greater awareness of the influences impacting our decisions.

In our efforts to making sound decisions, we want to know the circumstances and environment which encourage sound decision making.

"All I want to know is where I'm going to die, so I'll never go there" Charlie Munger

We need to be aware of the people agreeing (or disagreeing) with our emotions.

People of authority (especially those we admire) can influence us to make decisions which we otherwise might not make. This has been particularly relevant for us when peers (fund managers we admire) have made an investment, are positive on it, and reiterate that positivity to us.

We need to be conscious of our tendency to anchor on our initial decisions.

Once an investment is made, humans tend to stick with the decision despite obvious reasons to change our mind. It's common to rely on the first thesis and struggle to change our minds despite a range of new information made available.

We need to be particularly careful when making decisions in periods directly following large wins (or losses).

Our largest errors of judgement have come following periods of success. Naturally, we feel good after we've had investments go in our favour, but this creates hubris and can lead to some carelessness in our decisions immediately following.

We need to be conscious of our desire to be active.

Early in my career, I met two experienced investors who suggested their portfolio tends to do much better when they are on holidays. This remark was offensive to my young brash self, but it gets more sensible each year. There aren't that many great investment opportunities, so we need to be ok with long periods of inactivity.

We need to be aware of our tendency to be optimistic.

Many of us tend to want to believe a lofty forecast without building in appropriate margins for safety.

___

The notes above are an important list of the circumstances that have, in the past, skewed our decision making. In our efforts to improve our decisions (and results) over our next 10 years, we will be making particular effort to be conscious of them.

OTHER

Note on distributions.

Many of you reinvested your distributions instead of receiving cash.

Any taxable income (mainly net realised gains and income) is distributed at the end of each financial year. As the fund has a long-term focus on growth, ordinarily the distribution is a relatively small number compared to your total holding.

Due to the sale of Stratton Finance in 2022, the distribution was a particularly large number. As the deal was done on the final day of the FY, we didn't have sufficient time to amend distribution preferences.

Large distributions are an indication of strong returns and ordinarily are a good thing. But there are two by-products to be conscious of.

Firstly, distributions are taxable income which means tax needs to be paid. This was (understandably) surprising to some investors. In future, if the distribution is above average, we will proactively give investors the option to receive all or a portion of the distributions in cash to help fund any tax to pay.

Secondly, for those reinvesting distributions, this means you receive additional units and a higher average cost base to go with it. This narrows the gap between cost and value of your investment until the fund's unit price grows again.

Important to note that this a narrow gap between cost and value is not a fair reflection of the performance of your investment of the Lugarno Fund because a significant amount of your units were received via the distribution – not at the time you invested.

Acknowledgements: Charlie Munger, Lee Kuan Yew

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 fund's 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 herd-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 three 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 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
External Trustee fee	Trustee fee $40,000 pa (adjusted annual for CPI increases)
Fund operating expenses	The general expenses of operating of the fund and its investments are paid out of the fund

For investment enquiries:

Simon Harradence
0414 922 742
simon@lugarnopartners.com.au

For administration or application enquiries:

Julia Portus
0428 902 689
julia@lugarnopartners.com.au

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.