PINCHOT LANE PARTNERS, L.P.
140 W. Franklin Street, #222
Chapel Hill, NC 27516

July 15, 2019

To My Partners:

2019 Year-to-date ("YTD") Performance Summary

From January 1 to June 30, 2019, Pinchot Lane Partners LP ("PLP", the "Fund") returned 13.2%, net of 0.38% in management fees. Below is a summary of Fund performance during the 2019 first half period as well as since inception. I've also included a column for the performance of "ACP units," which show returns of my personal stake in the PLP portfolio since January 1, 2018 (prior to limited partners joining) compared to the S&P 500 index. The purpose of this column is to demonstrate what Fund performance would have been had the Fund started on the first of the year, which I think is a more useful comparison when evaluating against the index.

	(A)		(B)	= (A)-(B)
	ACP Units**	Pinchot Lane Limited Partners**	S&P 500 Total Return***	Relative Performance
2018 Calendar Year	*(2.3%)*	*N/A*	*(4.4%)*	*2.0%*
Fund inception thru 12/31/18*	*(10.3%)*	*(10.3%)*	*(9.1%)*	*(1.3%)*
2019 First Half	***13.2%***	***13.2%***	***18.2%***	***(5.0%)***
Annualized 1/1/18 - 6/30/19	***6.9%***	***1.1%***	***8.5%***	***(1.6%)***

** Fund inception was 1/22/18*
*** Fund returns are net of 0.75% annualized management fees*
**** S&P500 Total Return includes dividends*

The Fund underperformed the S&P 500 index on a YTD basis, as share prices of the Fund's concentrated portfolio of largely non-consensus ideas trailed an index increasingly comprised of large-cap technology names which rebounded strongly from dismal Q4 2018 performance. You can find out more about the Fund's top 5 positions in the attached Exhibit A (last page).

To reiterate what I've said before about performance measured over the short term: significant departures (both positive and negative) from index performance are to be expected and are very much a feature of PLP. Individual securities are selected to maximize long-term risk-adjusted return instead of tracking the S&P 500, in the hopes that after a multi-year period, the Fund comes out ahead and provides all partners with a more-than-satisfactory rate of return net of taxes.

While our benchmark is the S&P 500 (the next best alternative for partners' public equity exposure), the composition of the Fund's portfolio is truly independent and can contain a mixture of domestic and international securities, cash, fixed income, preferred

securities, and/or short positions. The portfolio is actively managed based on opportunities available within my circle of competence that offer significantly more upside than downside. As mentioned in the Fund's inaugural letter under "Ground Rules":

> *During particularly ebullient periods, I don't (and neither should you) expect the fund to outperform the major stock market indexes – it will most likely look like a laggard. There are several reasons for this – value tends to vanish during exuberant bull markets, and a fair amount of the fund's portfolio could be sitting in cash (or cash equivalents) during those heady times in the absence of attractive investments. Doing nothing (i.e. leaving a fair bit of the portfolio invested in nothing other than cash) is always an option. In the absence of identifiable value, we won't let "excess" funds burn a hole in the fund's pocket.*

While still far from the manic bull market of the late 1990s, the froth of the current investing environment suggests that it is a time to err on the side of prudence rather than aggression.

Musical Interlude

> *Is this the real life? Is this just fantasy?*
> *Caught in a landslide, no escape from reality*
> *Open your eyes, look up to the skies and see*
> *I'm just a poor boy, I need no sympathy*
> *Because I'm easy come, easy go, little high, little low*
> *Any way the wind blows, doesn't really matter to me, to me.*
> – Freddie Mercury (Queen, 1975)

In late December, following a fourth quarter S&P 500 decline of nearly 20%, I wrote to partners, "Investing during uncertain times requires faith that these challenges, too, shall pass." It didn't take long for U.S. equity markets to shrug off recessionary fears, as the index averaged over 3% monthly appreciation during the first six months of this year, again demonstrating that equity gains and losses (at least on paper) are "easy come, easy go." Boosted by sustained jobs and wage growth, low inflation, and a compliant Federal Reserve, equity indexes have regained their swagger and are once again trading at record highs.

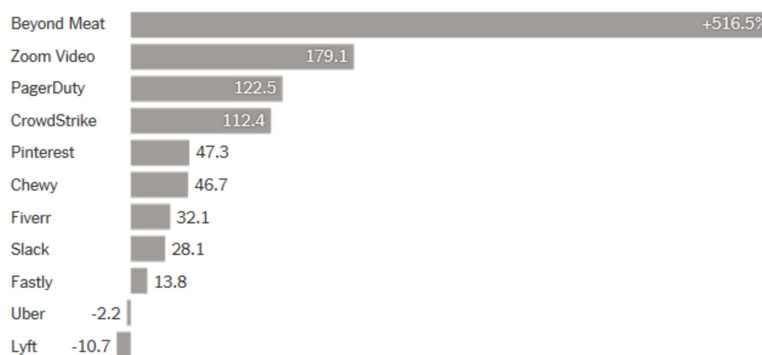
My job as an active investor is to ensure that I remain committed to the principles of rational investing, staying within my circle of competence and insisting on a healthy margin of safety. While macroeconomic cross-currents blow every which way, I find that microeconomic issues particular to portfolio companies are far more relevant to long-term outperformance, which is why I spend the vast majority of my energy deeply understanding these issues, instead of attempting to guess at more unknowable factors like interest rates, unemployment, trade imbalances, timing of recessions, and politics. While never entirely isolated from the ever-changing macro picture, investment

decisions founded on more intrinsic company and industry-specific issues have the best chances of repeated success.

Any way the wind blows doesn't really matter to me…

Anything goes that is an IPO

The latest raft of initial public offerings has become synonymous with "can't lose" propositions, which explains the incredible appetite for public market debuts of new-fangled growth companies. The average one-day price appreciation for IPOs this year is +34%[1]. IPO investors don't seem to regard a company's youth or lack of profits as impediments to stratospheric valuations. As a consequence, the throttle for newly listed issues remains wide open. Moreover, the breadth of companies executing "successful" IPOs is impressive, ranging from the more obvious (VC-funded information technology and biopharma startups) to the more innovative (fake meat) to the more speculative (marijuana companies, space tourism). In an investing environment in which the cost of money has been driven to all-time lows, a dollar and a dream might be all you need to launch a public company, at least for now.



In many ways, the torrent of hot money chasing IPOs signals the vibrancy of a free market economy full of entrepreneurial vigor – just what you'd want to see if you were a government official pointing to the health of a leading global economy. From a prudent investor's standpoint, however, an IPO market that snowballs in size and speed often signals an abandonment of fundamental investing principles, which calls for added vigilance in investment decision-making.

> *The question is, how long is this going to go on? At this rate, we could hit the all-time record of $96.9 billion raised in 2000. That, of course, was the internet bubble. Smith frets that as each deal succeeds, investors will get less disciplined, and the initial first-day pops we have seen so often will become a thing of the past. Take advantage of it while you can, Smith advises: "Any private company that is not proceeding to go public in this market should have their head examined. The market is wide open, and it's not always going to be."*[2]

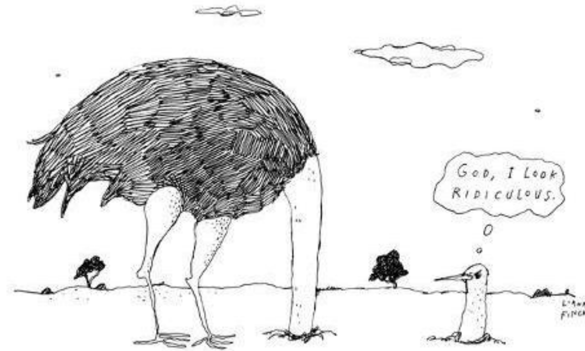
---

[1] "Lyft and Uber Were Duds, but the IPO Market is Having a Great Year," New York Times, June 24, 2019

[2] "IPOs have their best quarter in years," CNBC, June 28, 2019

Is this the real life? Is this just fantasy?

Ostrich Investing?



Readers may get the impression that in choosing to sit out the recent IPO bull rush and avoiding a more aggressive tilt toward high-growth technology names (e.g. Facebook, Apple, Amazon, Netflix, Google aka "FAANG" stocks), I have chosen to stick my head in the sand instead of recognizing broader shifts in market and industry leadership. Even Warren Buffett has added Amazon to the Berkshire portfolio! I assure you that I have not taken the ostrich approach to investing – while not a technologist by training, a semi-luddite like me still recognizes technological disruption when I see it. The predecessor of PLP (my personal investment portfolio starting from 2012) was invested in Netflix, Amazon, Google, and Zillow, all of which continue to be monitored as part of the Fund's "watch list." PLP's investment philosophy is not rooted in contrarian dogma. The real reason the Fund does not currently hold sizable stakes in FAANG stocks or their ilk is an issue of valuation. The same goes for evaluating the bumper crop of IPOs this year – there's no firm policy prohibiting investment in new issues, other than the fact that I try not to invest our capital in aggressively valued assets, especially those driven to extremes based on the unique auction dynamics of the IPO process. My objective is to produce the best risk-adjusted returns based on a reasonable set of assumptions, continuously evaluated. My current view, which is subject to change through rational, fundamentals-based analysis rather than the primal "fear of missing out," is that opportunities to own such names at compelling valuations don't exist. So far, no amount of mental contortion has enabled me to see value in a vast majority of these companies and believe me, I have tried. What happens to these crowded momentum trades at the next hint of a slowdown? If last year's fourth quarter was any indication, look out below. As long as highly exuberant conditions persist, I will need to search further afield in my quest for attractive investment ideas or wait for valuations to come back in.

I'm just a poor boy, I need no sympathy…

Great Companies vs. Great Investments

I'm not oblivious to the fact that today's technology companies have become an unprecedented force in the modern economy. In fact, I agree that there are compelling fundamental reasons that they now comprise seven of the top ten US-listed companies by market capitalization[3], up from just two a decade ago.

[3] BondCap "Internet Trends 2019" report, slide 13

From the perspective of generating attractive returns for partners, however, I question whether the optimal investment strategy is simply to invest in these names irrespective of valuation. Typically, superior risk-adjusted investment returns are found by: a) investing in an attractive asset largely unknown or untapped by others, b) underwriting a set of business outcomes that turns out more favorable than the consensus case, or c) seeing some way to unlock value in an asset that isn't already factored into the price. In all of these scenarios, superior returns require superior knowledge about an asset. Given that technology companies now lead the market in both size and investor attention, it's difficult to fathom how their growth prospects going forward aren't already priced into their valuations.

While many of today's mega-capitalization technology names are relatively young, recommendations to invest exclusively in the largest, most prominent companies as a path to easy returns is hardly novel advice. In the 1960s and early 1970s, it became a kind of personal finance orthodoxy that buying and holding a list of fifty popular, large-cap American companies (termed the "Nifty Fifty") could do no wrong:

> *These stocks had several traits in common during the early 1970s. They were growing both earnings and dividends. Their market capitalizations were large. Their prospects assumed to be bright. As such, investors ignored their valuations and happily paid significant premiums to own them. As those of you familiar with market history already know, the excitement about these stocks ended when their shares plummeted during the 1973-1974 bear market.*[4]

The notion of investing in the most visible, successful, and widely-held companies seems logical, albeit fundamentally flawed in its misunderstanding of how above-average, long-term investment returns actually work. Simply put, there is no asset so great that it is a great investment at any price. Of course, extremely popular companies do occasionally outperform the broader market for decades – Walmart (1970-1999), Costco (1985-present), Amazon (1997-present) – but these are the rare exceptions that prove the rule.

In Closing: Price Matters

I will close by repeating an old value investor adage that "price matters." It would seem obvious that those who know to "buy low and sell high" also know that "price matters," and yet investing crowds often forget that it does. The underlying principles of fundamentals-based investing dictate that generating consistently high returns hinges on buying at low prices relative to reasonable forecasts of intrinsic value, since the discount produces two-fold benefits – not only is the discount the source of investment returns, it also represents insurance against the event that one's forecast turns out to be wrong. Nevertheless, today's most popular momentum stocks often sport valuation multiples that assume unbridled prosperity and extrapolation of good times well beyond any prudent forecast. These names can still yield profitable returns if: (a) consensus

[4] "Are Any of the 'Nifty 50' Stocks Still Nifty?" Forbes, May 24, 2019

expectations prove to be too low, (b) market multiples go higher, and/or (c) these companies get acquired at healthy premiums. Of these three paths to nirvana, building an investment strategy around (a) qualifies as good investing, whereas the latter two tend to fall into the camp of speculation with returns predicated on factors extrinsic to the asset itself (e.g. momentum, trend-chasing).

While I realize that the original "dot com" boom of the late-1990s is quickly slipping into ancient history, that frenzied period still serves as an instructive example of what happens when the investing public loses sight of the "value for money" axiom. Shortly before its crushing -49% loss from 2000 to 2002[5], the S&P 500 index was trading at a nosebleed trailing price-to-earnings multiple of 35 times. It took seven years to regain its previous peak before collapsing again in the Great Recession of 2008. The technology-laden NASDAQ composite index traded at an even more hyperbolic 100 times price-to-earnings in 1999 and required nearly 15 years to recapture its prior peak.

Current price-to-earnings multiples for both indexes are more reasonable today (S&P 500: ~17.5x, Nasdaq: ~20x), but many of their largest and most popular constituents trade at far higher multiples (if they are profitable at all). Many active fund managers today base their investment strategies on cherry-picking the best-looking of these momentum stocks, a strategy that has worked well over the past five or six years. Combined with the passive ETF revolution which allocates investment according to market cap-weighted indexes, a perfect storm is under way in which highly valued assets get even pricier. Consider me old-fashioned, but I still believe that attractive bargains can be found among good quality assets using fundamental analysis, particularly in areas where few are looking for them. Price still matters.

> *If you went to the horse races, would you always bet on the favorite? The favorite, assuming the crowd is intelligent, which usually it is, is the horse with the highest probability of winning. That doesn't mean the favorite is always the best bet. You might have another horse that has a lower probability of winning but the odds are so much higher, that's the smart bet.*
> – Howard Marks, Oaktree Capital[6]

The Fund welcomed a new limited partner this year and is open for further investment by both new and existing partners. Despite broad market indexes feeling fully valued at the moment, one doesn't need to look hard to find underpriced bargains outside of the technology sector. At the Fund's current size, we won't exhaust capacity in our primary value-seeking investment strategies any time soon.

As usual, please let me know if there is anything unclear in these letters, if you have any questions, or if there are better ways to communicate with you about your partnership investment. Unless something comes up, the next letter you'll receive from me will be in January 2020.

---

[5] "11 historic bear markets," NBC News
[6] Howard Marks quotes, Value Investing World

Sincerely,

Drew Peng

Attached: PLP Top 5 Portfolio Positions as of June 30, 2019

<u>Exhibit A</u>: Pinchot Lane Partners - Top 5 Portfolio Positions as of June 30, 2019

Name	Symbol	Description	Investment Thesis	% of Portfolio Value	Date of initial investment
Hostelworld	HSW.L	Ireland-based leading global online travel agent (OTA) serving the niche hostel/backpacking market	Traded on LSE, HSW valuation declined nearly 50% during second half of 2018, precipitated by a single large shareholder exiting stake in a low liquidity environment; Company is fundamentally healthy, profitable, and leads an attractive, underserved traveler niche with a highly tailored, app-driven approach	11.4%	Sep-2018
XPO Logistics	XPO	Highly integrated provider of transportation and logistics in N. America and Europe; company was formed through a rollup of 17 different acquisitions led by an experienced entrepreneur who used a similar strategy to build and successfully exit two multi-billion companies (United Waste and United Rentals)	Transportation and logistics is a large, fragmented industry and XPO has few comparables who have adopted its integrated approach to delivering customer solutions; XPO's technology-led approach seems poorly understood despite a strong track record of gaining market share and substantially improving margins since completing its last acquisition in 2015	11.2%	Feb-2019
Booking Holdings	BKNG	The leading global OTA platform for travel, hotel, activities, and other lodging accommodations with brands such as Priceline.com, Booking.com, Kayak, OpenTable, Agoda, RentalCars.com	Opportunity to own the largest, most profitable player in the OTA sector that continues to take share of $1.6 trillion global travel market, with leading positions in most developed markets excluding China; OTA industry has demonstrated countercyclical, recession-resistant attributes	8.8%	Dec-2018
Purple Innovation	PRPL	A leading consumer comfort brand with substantially differentiated product technology (hyper-elastic polymer grid); Purple is a vertically-integrated designer and manufacturer of mattresses, bedding accessories, seat cushions, and pet beds	Rapidly growing direct-to-consumer mattress industry (which now represents over 10% of the $17b domestic market); Purple wholesale channel sales show explosive growth and brand has built a large consumer following; patented technology differentiates company from proliferation of foam-based competition; valuation substantially below private market comps; new CEO successfully executing operational turnaround	7.8%	Apr-2018
Viasat	VSAT	Provider of satellite equipment and communication services for government/defense sector, consumer broadband, rural community wifi, and commercial aviation	Lowest cost satcom provider on critical cost per bit capacity metric; technology is years ahead of primary competitors; potential to become first truly global internet service provider post-launch of next-generation, advanced Viasat-3 satellite constellation (currently under construction); has taken significant market share of commercial airline connectivity	7.7%	Jun-2012
			Total Top 5	**46.8%**	