PINCHOT LANE PARTNERS, L.P.
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Carrboro, NC 27510

February 7, 2024

To My Partners:

2H 2023 Performance Summary

From January 1 to December 31st, 2023, Pinchot Lane Partners LP ("PLP", the "Fund", the "Partnership") returned 32.9%, net of management fees (waived since Q2 2022). For partners invested in the Fund since 2020, no incentive fees were paid, as the Fund's performance did not exceed the highwater mark set in 2020. Below is a summary of Fund performance for 2023 and since inception:

	PLP Gross Perf	(A) PLP Net Perf**	(B) S&P 500 Total Return†	= (A)-(B) *Relative Performance*
1/22/18* to 12/31/18	(9.6%)	(10.3%)	(9.1%)	*(1.3%)*
1/1/19 to 12/31/19	31.1%	28.9%	31.5%	*(2.6%)*
1/1/20 to 12/31/20	128.3%	97.2%	18.4%	*78.8%*
1/1/21 to 12/31/21	(25.6%)	(26.1%)	28.7%	*(54.8%)*
1/1/22 to 12/31/22	(26.3%)	(26.4%)	(18.1%)	*(8.3%)*
1/1/23 to 12/31/23	**32.9%**	**32.9%**	**26.3%**	***6.6%***
Annualized 1/22/18*-12/31/23	**12.1%**	**8.7%**	**11.2%**	***(2.5%)***

** Fund inception*
*** Management fee has been waived since 2Q 2022.*
Net performance after mgmt fee and incentive allocation (cumulative 6% hurdle subject to high water mark).
† S&P500 total return includes dividends.
Note: Individual LP returns may vary based on the date of your subscription(s).

The majority of the Fund's performance in 2023 was driven by ideas initiated in 2022, when overall economic prospects looked bleak and stock market indexes were in steep decline. Partners may recall my Partner Update in May 2022, in which I excerpted a chart from CNN's "Fear & Greed Index" showing investor sentiment pegged to "Extreme Fear." Reflecting on market developments since then, I'm reminded of the investing maxim, *"The time to buy is when there's blood in the streets, even if the blood is your own."* It is a statement worth remembering, particularly during markets riddled with fear, uncertainty, and doubt. Hardening oneself to such turbulent periods is usually a good foundation from which to generate solid returns. When storm clouds dissipate, we often find that reality is less bad than feared and that in retrospect, high quality assets were offered at bargain prices.

<u>What Worked Well and Why</u>

Both 2022 and 2023 presented opportunities to buy high quality assets at reasonable prices. PLP managed to acquire a few great assets in the past 18 months that carried the Fund in 2023, as described below:

- Widely-recognized, secular growth companies acquired during periods of widespread pessimism, leading to reasonable entry valuations *(Google, Apple, Taiwan Semiconductor)*
- Industrial distributors that were perceived to be one-time pandemic beneficiaries, but are *actually* well-positioned for long-lasting, secular growth trends in housing and infrastructure markets *(Ferguson, Core & Main)*
- Homebuilding companies that continue to benefit from the shortage of housing, exacerbated by low supply of existing homes and growing household formation *(Meritage, M/I Homes)*
- A merger arbitrage (spread between an acquisition target's market price and the value delivered upon a consummated transaction) that was completed, realizing proceeds in cash and shares of a best-in-class technology conglomerate *(Broadcom's acquisition of Vmware)*

The Fund's gains in 2023 were not broadly distributed across the portfolio. Instead, they were driven by 8-9 names in a portfolio that averaged 20-23 companies throughout the year. Thankfully, our concentrated investments performed well, offset by several which did nothing and a handful which were truly awful, but small-sized. Batting anywhere close to 1.000 in investments is impossible. We hope to upsize investments in our most compelling names, such that being right in our biggest names offsets being wrong elsewhere in the portfolio.

Additionally, I am pleased that there were far fewer portfolio transactions (buys and sells) in 2023 as compared to 2022, by about half. This was primarily a function of feeling more confident about what we owned heading into 2023 after aggressively turning over the portfolio in 2022 in search of better value and higher quality. The benefit to you as a Limited Partner is manifold: lower turnover yields better tax efficiency, and infrequent trading means less time and effort "reading the market," an activity that distracts from our goal of long-term compounded returns. This last point reveals the most important aspect of the PLP value creation philosophy. The Fund grows in value by *staying invested over the long term in stellar businesses* run by competent management, *not* by deftly trading stocks. Which is just as well, since my skills in the latter area are virtually non-existent.

My ambition in 2024 is to trade even less. The avoidance of manic trading enables more selectivity which means that higher quality assets are held in the portfolio. If I can accomplish even modest success in identifying and acquiring the best quality assets at reasonable prices, there will be little need to turn over the portfolio in search of returns – the assets themselves will be the engines that generate long-term compounded gains.

What Didn't Work and Why

In a manner of wishful thinking, I expected better outcomes for several consumer discretionary holdings despite their poor performance in 2022. For these companies, not only did business *not* rebound in 2023, conditions worsened leading to steep valuation declines in lockstep with dwindling profits. These losers were a meaningful drag on the strong performance of our winners. Waiting for the cycle to turn for these companies has begun to resemble the stage play "*Waiting for Godot*" – uncertain, unclear, and "*surely tomorrow*." Although cyclical, discretionary companies can be impressively profitable in certain periods, their peaks tend to be offset by severe downcycles of indeterminate length, which makes investing in them an exercise in timing and patience. Holding meaningfully-sized positions in this handful of names was a mistake. If the demand environment for these companies improves, I expect that the valuation for these assets will rebound strongly (otherwise, I wouldn't continue to own them). But, as always, the timing and path of recovery is unknown. Collectively, these names represented less than 7% of the overall PLP portfolio as of 12/31/23.

We live and learn.

What is Quality?

> *"Care and Quality are internal and external aspects of the same thing. A person who sees Quality and feels it as he works is a person who cares. A person who cares about what he sees and does is a person who's bound to have some characteristic of quality."*
>
> – Robert Pirsig, *Zen and the Art of Motorcycle Maintenance (1974)*

> *"To get what you want, you have to deserve what you want."*
>
> – Charlie Munger

In a market that is constantly shifting its focus to what is working *in the moment*, it's critical for long-term investors to anchor themselves to a set of robust criteria that act as hard filters for the kinds of assets that enter the portfolio. "Quality" can be a nebulous term, so I thought that it would be helpful to put some meat on the bones of this often-used but difficult-to-define term. The following table is an attempt to enumerate what I think are some of the most important aspects of Quality in companies.

Characteristics of Quality in Companies
Management Credibility and Shareholder Alignment • Management team and governance model that is *aligned with common shareholders* • Management team that has *earned* a reputation for being trustworthy, knowledgeable, and credible ("seamless web of deserved trust") • A management team that consistently delivers on what it promises, *without making excuses* • An employer of first choice among peers

Advantaged Competitive Position • Broad and deep competitive moats • An indisputable industry leader or at minimum, a credible path to getting there
Superior Business Economics • Attractive returns on invested capital (ROIC), <u>*through the business cycle*</u> • Generation of robust free cash flows available to common shareholders <u>and</u> for accretive reinvestment, and a management with a history of skilled capital allocation • Sound, fortress-like balance sheet • Prudent use of leverage (debt)
Limited Risk Factors • Reasonably predictable business with growing demand over time (not the same thing as noncyclical) • Rational industry conduct • Benign regulatory environment • Minimal-to-low sovereign/geopolitical risk • Minimal threat of technological or business model disruption • Avoidance of influential/controlling shareholders that are not fully aligned with us

I am not proud to say that there have been episodes when we have owned too much "Un-Quality" when I judged that there wasn't enough Quality available within my circles of competence at a reasonable price. When this happens going forward, we will just hold cash, especially as it's now paying us to hold it. Investors focused on long-term appreciation would do well to remember that "slow and steady wins the race." I'm not planning to change the name of our Fund to "Turtle Capital Partners LP," but you get the point.

In the end, Quality is never having to apologize for having invested other people's money in an asset.

<u>Thoughts on Artificial Intelligence (AI)*</u>

> *"If I should really want to answer the foolish question you have just asked, or any of the other questions you have been asking me, let me remind you that I have a row of electric push-buttons on my desk, and by pushing the right button, I can summon to my aid men who can answer ANY question I desire to ask concerning the business to which I am devoting most of my efforts. Now, will you kindly tell me, WHY should I clutter up my mind with general knowledge, for the purpose being able to answer questions, when I have men around me who can supply any knowledge I require?"*
>
> - Henry Ford in 1919, testifying in court against his own ignorance - a quote that might one day come from an AI power-user

"AI is perhaps the most general of all general purpose technologies because it is going after intelligence. If we can 'solve intelligence,' we can use that to solve a lot of other problems in the world."

- Erik Brynjolfsson, Professor and Senior Fellow at the Stanford Institute for Human-Centered AI, quoted in FT "Economists Exchange," Jan 31, 2024

While AI developments are still in the early innings, it does feel like AI will have widespread applications across society and the economy, certainly more so than other recent "innovations" like cryptocurrency, NFTs, the metaverse, and on-demand food delivery. If you've already used AI for daily work, you've likely come to appreciate its unique capabilities to aggregate information, summarize it, and provide useful, coherent suggestions as if it fundamentally understood the gist of the topic or question posed to it. In the graphics arena, AI is already capable of rendering life-like images based on rudimentary prompts. In the audio realm, AI has shown its ability to mimic styles of speech, tone, and word choices of any person for which it has training data. In short, AI has demonstrated abilities to reason like us, see like us, and sound like us (i.e., robots).

One could easily go down a rabbit hole thinking about all the places that AI robots could take us and all the jobs they could replace. The point here is not to delineate every possible use case but to point out that the markets to which AI could apply are numerous, which is why a handful of the largest companies in the world are investing enormous sums in pursuit of the opportunities ahead.

If AI is set to be the next Industrial Revolution, it will be expensive. Nvidia's flagship GPU (graphics processing unit) that runs large language models is priced at $30,000…for one unit. Instead of thinking of these devices as mere chips, we ought to think about them as large appliances. Big tech companies and wealthy institutions purchase Nvidia GPUs in the *tens of thousands of units*. Collectively, that is hundreds of thousands of units (tens of billions of dollars) purchased inside of a year. There has probably never been a more capital-intensive period in the history of computational processing, with tech giants engaged in a massive arms race to bring AI products to market. Closely following the investment phase of building AI functionality, early adopters of AI might enter into a subsequent arms race to gain competitive edges.

Knowing the current state of play in the AI revolution is interesting, but as investors we also seek to identify compelling investment opportunities in the AI ecosystem. During the initial phases of a technological hype cycle like the one we're in now, the types of investments that I'm comfortable making (bargains hiding in plain sight) tend not to be obvious. Moreover, there are simply too many questions when attempting to separate hype vs. reality and long-term winners vs. losers. For now, I'll content myself with asking Google's Bard to generate corny investing jokes.

** Note: this Letter was not outsourced to AI, all errors are my own.*

Farewell, Charlie Munger
One of my favorite quotes (among many):

Charles T. Munger
(1924-2023)

> *CHARLIE MUNGER: You know, I said on another occasion that, to some extent, stocks sell like Rembrandts. They don't sell based on the value that people are going to get from looking at the picture. They sell based on the fact that Rembrandts have gone up in value in the past. And when you get that kind of valuation in the stocks, some crazy things can happen. Bonds are way more rational, because nobody can believe that a bond paying a fixed rate of modest interest can go to the sky, but with stocks they behave partly like Rembrandts. And I said, suppose you filled every pension fund in America with nothing but Rembrandts? Of course, Rembrandts would keep going up and up as people bought more and more Rembrandts, or pieces of Rembrandts, at higher and higher prices. I said, "Wouldn't that create a hell of a mess after 20 years of buying Rembrandts?" And to the extent that stock prices generally become sort of irrational, isn't it sort of like filling half the pension funds with Rembrandts? I think those are good questions.*
>
> *WARREN BUFFETT: Once it gets going, though, people have an enormous interest in pushing Rembrandts. I mean, it creates its own constituency.*

In Closing
Thank you for the opportunity to keep serving you. I understand that I need to earn your trust and capital on an annual basis, and I appreciate that you have remained a loyal partner on this journey despite its twists and turns over the years.

As broader markets have transitioned from fear to greed in relatively short order, it is more challenging to find new opportunities capable of producing compelling returns, which is why it's even more important to be patient and selective. High quality companies with talented management in our portfolio are working to grow our capital so that even when there are few new opportunities to act on, we can bide our time by letting these compounding engines grow undisturbed.

Housekeeping

Once again, Akram & Associates are preparing Partnership tax returns for 2023. K-1 forms should be available to you no later than mid-March.

My line is open should you have questions and/or comments. I always appreciate hearing from Partners.

Sincerely,

Drew Peng