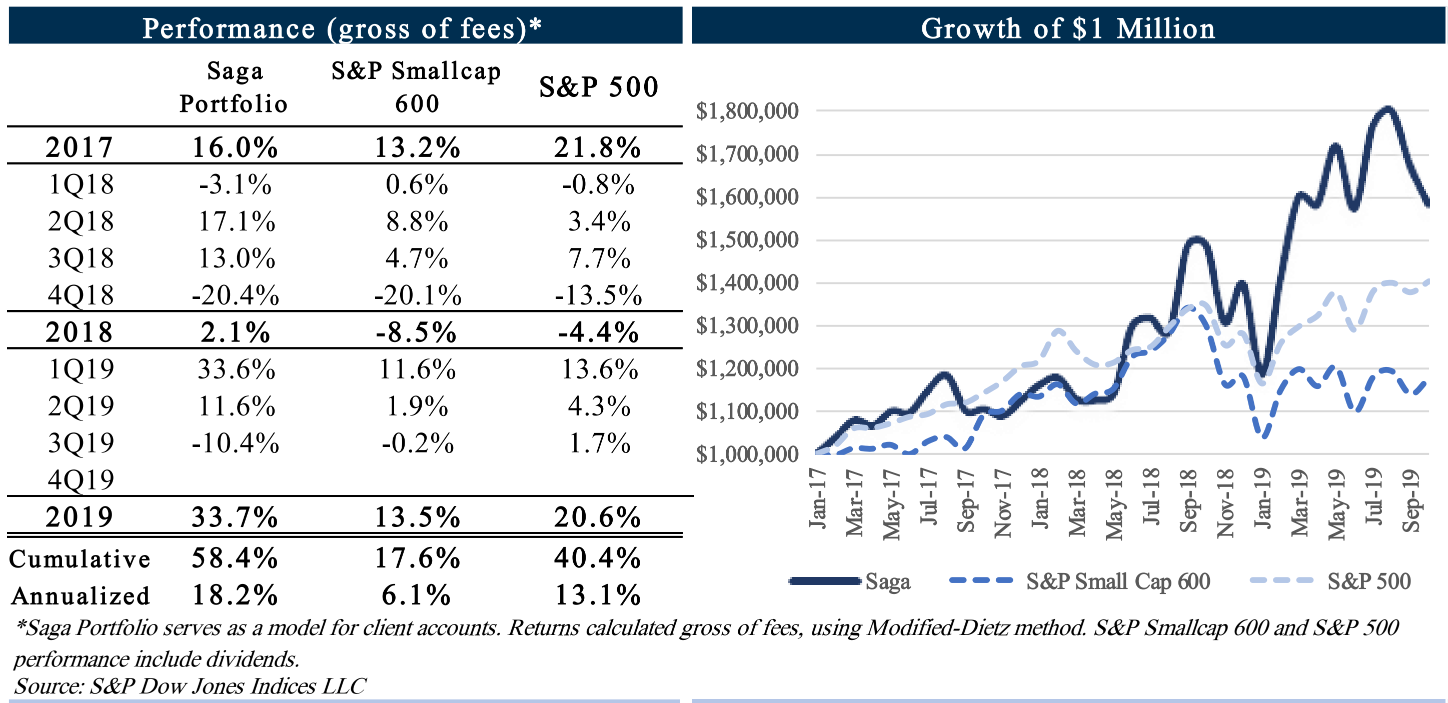
QUARTERLY REPORT

THIRD QUARTER 2019

3Q19 Results

During the third quarter of 2019, the Saga Portfolio ("the Portfolio") decreased 10.4% gross of fees. This compares to the overall decrease, including dividends, for the S&P Smallcap 600 Index of 0.2% and increase for the S&P 500 Index of 1.7%.

The cumulative return since inception on January 1, 2017 for the Saga Portfolio is 58.4% gross of fees compared to the S&P Smallcap 600 Index and the S&P 500 Index of 17.6% and 40.4%, respectively. The compounded annual return since inception for the Saga Portfolio is 18.2% gross of fees compared to the S&P Smallcap 600 and S&P 500's respective 6.1% and 13.1%.



Performance (gross of fees)*

	Saga Portfolio	S&P Smallcap 600	S&P 500
2017	**16.0%**	**13.2%**	**21.8%**
1Q18	-3.1%	0.6%	-0.8%
2Q18	17.1%	8.8%	3.4%
3Q18	13.0%	4.7%	7.7%
4Q18	-20.4%	-20.1%	-13.5%
2018	**2.1%**	**-8.5%**	**-4.4%**
1Q19	33.6%	11.6%	13.6%
2Q19	11.6%	1.9%	4.3%
3Q19	-10.4%	-0.2%	1.7%
4Q19			
2019	**33.7%**	**13.5%**	**20.6%**
Cumulative	**58.4%**	**17.6%**	**40.4%**
Annualized	**18.2%**	**6.1%**	**13.1%**

**Saga Portfolio serves as a model for client accounts. Returns calculated gross of fees, using Modified-Dietz method. S&P Smallcap 600 and S&P 500 performance include dividends.*
Source: S&P Dow Jones Indices LLC

Market Outlook

There is a section in the book *Naked Economics* by Charles Wheelan that looked like a similar answer to the one we give when anyone asks what we think the market is going to do:

> "Where will the Dow close tomorrow? I have no clue. Where will it be next year? I don't know. Where will it be in five years? Probably higher than it is today, but that's no sure thing. Where will it be in twenty-five years? Significantly higher than it is today; I'm reasonably certain of it."

There is an enormous amount of money around the world that is managed by an electronic herd of people who think that a decision needs to be made on everything in their portfolio every single day.

We understand the innate worries and seemingly heightened level of uncertainty in the global economy. There are growing government debts and fiscal deficits, trade tensions with China, ongoing central bank stimulus to boost economic growth while market forecasters claim we are "due" for a correction. However, when is there not a heightened sense of uncertainty in the markets? And when markets do inevitably panic again, as they did in the fourth quarter of last year, will investors then overcome their fears and say now is the right time to invest? Or will they wait until things calm down and become less uncertain?

We are certain that another recession will happen sometime in the future, but we do not know when it will happen, how long it will last, or how extreme it will be. We do not even know how the market will react going into and coming out of it. We do know during 2008 following the Lehman Brothers bankruptcy and subsequent financial meltdown, the outlook at the market lows was far from certain. We prefer to keep our heads down, ignore the noise, and simply look for the best opportunities we can find given the information we have today.

Management Fees

We are now reporting the Saga Partners returns *gross* of fees instead of *net* of fees. At the end of the day, all that matters to an investor is the money they can take home and spend after paying all fees, therefore it's net results that matter. The reason for the change is because we have a few early investors that have a different fee rate than the 1.5% AUM we currently charge. Reporting gross returns provides a more consistent report for all parties and each investor can deduct/net out the quarterly fee that was charged to their account which is 0.375% (1.5%/4) of assets managed at the beginning of the period for most accounts. You can also check your brokerage statement and simply calculate the change in your balance from period to period to calculate your net returns.

It's important to understand all fees that you may be paying for any investment services. We've met with many individuals that do not even know what they are paying for the different investment funds they may be in since brokerage statements often make it difficult to know the actual dollars/fees being paid.

Investment managers are typically paid by either an assets under management (AUM) fee, a performance fee, or a combination of both. Saga Partners only charges an assets under management fee and no performance fee. We like this structure because it is simple and straightforward.

In their heyday, hedge funds historically charged a 2% AUM fee and 20% performance fee. As hedge fund performance has been lackluster over the past decade, a 1.5% AUM fee and a 15% performance fee have become more common. When Warren Buffett ran his investing partnership

in the 1950s-1960s, his fee structure had no AUM fee and a 25% performance fee above a 6% hurdle. Unlike most hedge funds, Buffett only got paid if he performed.

A performance fee is calculated as a percentage of the investment returns. Its purpose is to incentivize investment managers to earn strong returns for the portfolio. While there can be some truth to that, when we look over the actual net results of the majority of hedge funds or mutual funds that charge performance fees, it is very rare to find funds that provide market beating returns net of fees throughout a full market cycle.

It doesn't matter how much money a portfolio manager charges *as long as they are able to beat their benchmark* by a wide enough margin over time *after fees are deducted*. Paying for strong outperformance makes sense but too often fees are excessive relative to the value a fund manager provides. The more commonly used performance fee structures make it very difficult and nearly impossible for a fund to outperform over time. Too often the portfolio manager makes a killing while their clients get lackluster results.

Below are four examples of different fee structures: 1) the typical hedge fund structure of 1.5% AUM and 15% performance fee, 2) 2.0% AUM and 20% performance fee, 3) the fee structure that Buffett used during his investment partnership, and 4) Saga Partners' 1.5% AUM and 0% performance fee.

	Fee Structure	
1	Hedge Fund A	1.5% AUM, 15% Performance
2	Hedge Fund B	2.0% AUM, 20% Performance
3	Buffett Partnership	0.0% AUM, 25% Perf. over 6% Hurdle
4	Saga Partners	1.5% AUM, 0% Performance

Over the past 25 years, the S&P 500 provided a total compounded annual growth rate (CAGR) of 9.8%. Below is a chart showing the required gross return (before fees are charged) that would be required for the fund to simply match the S&P 500's performance after charging fees.

Hedge Fund A and B would have had to provide gross annual returns of 13.0% and 14.3% respectively to simply match the S&P 500's 9.8% CAGR. The Buffett Partnership structure would have had to provide 11.1% gross annual returns, and Saga Partners would have had to provide 11.3% gross annual returns.

0% Outperformance After Paying Fees

	Required Gross Returns	AUM Fee	Performance Fee	Total Fees	Portfolio Net Returns	Outperformance
1	13.0%	1.5%	1.7%	3.2%	9.8%	0.0%
2	14.3%	2.0%	2.5%	4.5%	9.8%	0.0%
3	11.1%	0.0%	1.3%	1.3%	9.8%	0.0%
4	11.3%	1.5%	0.0%	1.5%	9.8%	0.0%

Source: Saga Partners

Given all the time, effort, and resources put into managing an investment portfolio, hopefully investors in the portfolio would receive some outperformance or else they might as well simply invest into a low-cost index fund.

Assume you would like the fund to outperform the S&P 500 by at least 5% annually. Hedge Fund A and B would have had to provide gross annual returns of 18.9% and 20.5% respectively. The Buffett Partnership would have had to provide 17.7% gross annual returns and Saga Partners would have had to provide 16.3% gross annual returns. Note this does not include the taxes investors would have to pay along the way depending on the level of turnover of the strategy.

5% Outperformance After Paying Fees

	Required Gross Returns	AUM Fee	Performance Fee	Total Fees	Portfolio Net Returns	Outperformance
1	18.9%	1.5%	2.6%	4.1%	14.8%	5.0%
2	20.5%	2.0%	3.7%	5.7%	14.8%	5.0%
3	17.7%	0.0%	2.9%	2.9%	14.8%	5.0%
4	16.3%	1.5%	0.0%	1.5%	14.8%	5.0%

Source: Saga Partners

Outperforming the index by 5% is significant, providing over 200% greater value at the end of the 25-year period. However, to get that 5% outperformance a hedge fund with a standard fee structure would have had to earn ~20% gross returns. The number of funds that were able to earn greater than 20% gross returns over that period were few and far between and those that did are held up as investing prodigies. Investors paying these types of fees should understand that they are betting that the specific strategy will require Warren Buffett-like returns in order to earn a few points of "alpha."

Evolution of a Value Investor

It seems as though the learning curve of a "value" investor often follows a similar path; at least this was the case from our personal journey and the few other portfolio managers we know that share a similar investing philosophy. Perhaps one of the most common tendencies of investors early on in their journey was relying almost entirely on quantitative metrics and underweighting the importance of qualitative factors of businesses and its managers. We were no exceptions.

The story often starts with a curious business student that comes across some narrative or writings about Warren Buffett. They are captivated by the idea of compounding money by buying things for less than they are worth. Hungry to learn more, they read everything they can find on Warren Buffett, Ben Graham, Charlie Munger and all the other well-known value investors.

Anxious to grow their capital and working with relatively small sums of money, they try to emulate Buffett in his early days, searching the universe of publicly traded companies selling for low multiples to earnings, cash flow, or book value. There is just something appealing to paying 10x current earnings vs. 20x.

While the young investor experiences a few token successes, they start realizing that times have changed since the decades following the Great Depression and few of Ben Graham's net-nets (companies selling for less than their working capital) exist. Too often when weighting valuation before quality, they find themselves owning mediocre companies that only appear to be selling for an attractive valuation but remain perpetually "undervalued" as operating results continue to disappoint. Although it is true that almost any asset can be attractive at the right price, it is very difficult to do well owning a bad business over the long term.

Additionally, if you buy something because you think it's slightly undervalued merely based on some quantitative metric, then you have to think about selling when it approaches your estimate of fair value. If a good company is selling for 10x free cash flow and you think a more fair valuation is 15x, as shares approach 13x, is there still enough margin of safety to justify holding it? Trying to guess if the market will rerate the valuation multiple applied to a company is a tough game to play. The real big money is made by owning a handful of companies that compound business intrinsic value over decades; not so much from the occasional one-time closure of gap between price and value.

It becomes increasingly obvious that some of the best opportunities are companies that generate high returns on capital and require little additional capital to grow further. These opportunities exist because the market can underappreciate the intrinsic value since these companies rarely look cheap based on standard valuation metrics. If the market is selling for an average earnings multiple of 16x-18x, any company selling at a higher multiple looks relatively expensive, and any company selling lower looks relatively attractive. This may be a reasonable conclusion for an average company, but companies are not all alike and the difference between an exceptional company that is scaling and an average one can be huge.

As the young investors continues the never-ending process of learning and improving, they devote themselves to studying the exceptional businesses that exhibit competitive advantages; finally appreciating that the value in investing is in the qualitative analysis.

Compounders and Fair Valuation

Below is a list of some of the best performing stocks over the last 15 years (2004-2019). You could argue that Booking Holdings Inc. was undervalued by 24x in 2004, meaning that when shares were selling for $20, they could have been selling for $480 (26x sales) and still earned the market's return over the subsequent 15-year period. The 2004 fair value for Old Dominion Freight, a best-in-class trucking company, would have been 101x its 2004 earnings. Alphabet Inc., Google's parent company, could have sold for 73x its 2004 sales and 515x earnings to provide the market's return.

Company Name	15 Yr. CAGR (2004-2019)	2004 Shares Undervalued By:	2004 Fair Value Multple	
			P/S	P/E
Booking Holdings Inc.	35%	24x	26x	678x
Apple Inc.	34%	22x	34x	468x
Amazon.com, Inc.	28%	12x	36x	618x
salesforce.com, inc.	27%	10x	386x	13072x
Tyler Technologies, Inc.	25%	8x	16x	264x
Credit Acceptance	24%	7x	14x	43x
IDEXX Laboratories, Inc.	23%	6x	12x	82x
O'Reilly Automotive, Inc.	22%	6x	5x	70x
Old Dominion Freight	22%	5x	5x	101x
Alphabet Inc.	22%	5x	73x	515x
Ross Stores, Inc.	22%	5x	3x	64x
Copart, Inc.	21%	5x	13x	52x
Domino's Pizza, Inc.	21%	5x	2x	45x

Source: Saga Partners, Factset Research Systems
Note: Returns calculated from 9/30/04 through 9/3019

Hindsight is always 20/20 in investing. It's easy to look back at which companies succeeded and others failed and we are not arguing that valuation does not matter. Valuation is crucial to investing, as is building in a margin of safety. There is not a more guaranteed way of getting low returns than paying too much for an asset, but you can see from the chart above how the truly exceptional companies with significant growth opportunities could sell for multiples that look ridiculous at the time when compared to market averages. It might just make sense to pay up a bit for the few exceptional companies out there.

There are just under 2,000 U.S. companies publicly traded today that were publicly traded 15 years ago. About 580, or 30%, of stocks beat the S&P 500's 9% CAGR over that period. In other words, in 2004 ~30% of public stocks were undervalued and ~70% were overvalued relative to the S&P 500. The few successful companies contributed more to the overall average returns. This sample size does not even include all the companies that either went out of business, were acquired, or taken private. Blindly picking companies from a bowl or having a monkey randomly throw darts at all available stocks in 2004 would likely not result in a winning strategy over the subsequent 15-year period.

There were about 190 companies (<10% available) that provided a 15%+ CAGR and about 70 companies (<4%) that provided a 20%+ CAGR. Was it possible in 2004 to determine that Booking Holdings Inc. would come to dominate the online travel agency industry, Amazon would be the e-commerce winner and start AWS, Credit Acceptance Corp's differentiated auto lending business model would not be replicated by competitors, or Google's search engine would establish monopoly status while Android became the primary cell phone operating system

throughout most of the world? These are not easy business achievements to predict, but you did not have to predict all of these successes in 2004, just a token few would have worked.

Unfortunately we only have the information available today to help pick the winners over the next 15-year period. We are not trying to predict every business success and we are certain to miss out on many big winners. But if we work very hard, we may be able to find just a few things every once in a while that are very likely to do well over time.

Conclusion

We are grateful for the opportunity to manage our investors' hard-earned capital. The success of the Saga Portfolio requires investors that are stable, long-term, and realistic in their expectations. As always, please reach out if you have any questions or comments, we are always happy to hear from you!

Sincerely,

Joe Frankenfield

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