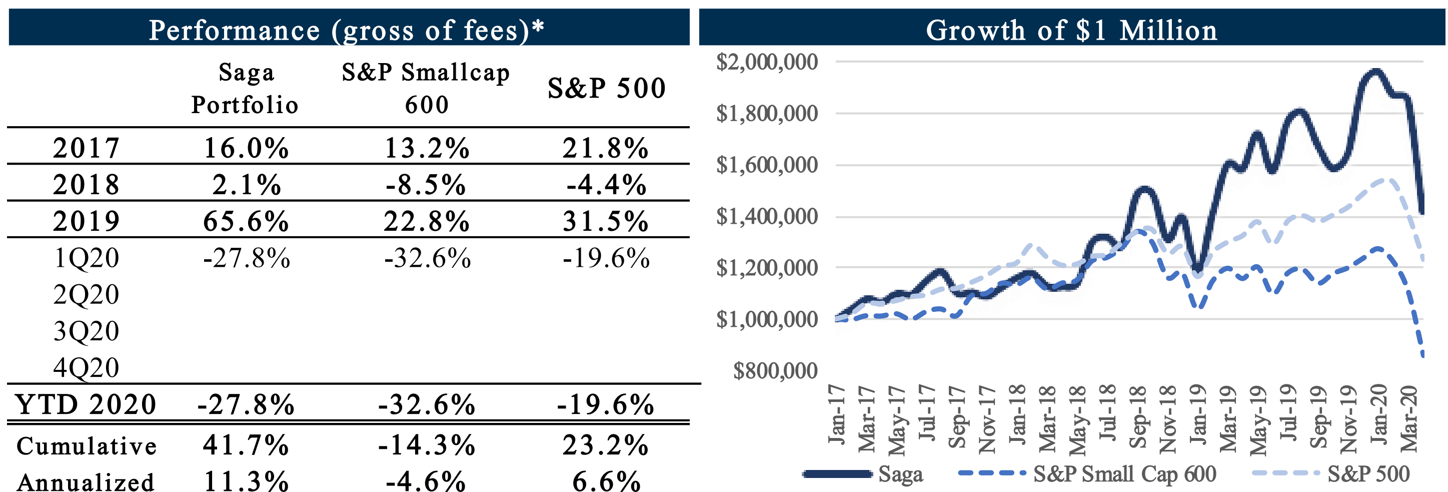
QUARTERLY REPORT

FIRST QUARTER 2020

1Q20 Results

During the first quarter of 2020, the Saga Portfolio ("the Portfolio") decreased 27.8% gross of fees. This compares to the overall decrease, including dividends, for the S&P Smallcap 600 Index and S&P 500 Index of 32.6% and 19.6%, respectively.

The cumulative return since inception on January 1, 2017 for the Saga Portfolio is 41.7% gross of fees compared to the S&P Smallcap 600 Index and S&P 500 Index of -14.3% and +23.2%, respectively. The annualized return since inception for the Saga Portfolio is 11.3% gross of fees compared to the S&P Smallcap 600 and S&P 500's respective -4.6% and 6.6%.



Performance (gross of fees)*

	Saga Portfolio	S&P Smallcap 600	S&P 500
2017	16.0%	13.2%	21.8%
2018	2.1%	-8.5%	-4.4%
2019	65.6%	22.8%	31.5%
1Q20	-27.8%	-32.6%	-19.6%
2Q20			
3Q20			
4Q20			
YTD 2020	-27.8%	-32.6%	-19.6%
Cumulative	41.7%	-14.3%	23.2%
Annualized	11.3%	-4.6%	6.6%

**Saga Portfolio serves as a model for client accounts. Returns calculated gross of fees. Assuming 1.5% AUM fee since inception would provide an annualized net return of 9.8%. S&P Smallcap 600 and S&P 500 performance include dividends.*
Source: S&P Dow Jones Indices LLC

Market Commentary

We were originally planning on switching to semi-annual letters but given recent events related to the COVID-19 pandemic, investors may welcome another quarter of the Saga philosophy and our thoughts surrounding the current situation.

During the last quarter, the S&P 500 experienced the fastest decline of over 30% in the history of the stock market and the second largest single day loss ever. The sharp drop in the stock market was broad-based and affected most stocks. Shares of businesses related to hospitality, "non-essential" retail, and travel have been particularly hard hit as they have been directly impacted by the stay-at-home orders and government mandated shutdowns of the economy.

We have little to add to the evolving dialogue surrounding the virus' health implications. Even the certified epidemiologists seem to be struggling to wrap their heads around the virus which no one had heard of before last December. Our basic understanding is the virus is very contagious

and while not very harmful to the majority of people, can be very harmful to those with compromised immune systems and the elderly, potentially overwhelming hospital systems in badly affected areas.

Regarding the economy, it is pretty apparent that the U.S. and much of the world has entered a recession. Recessions are technically defined as two or more quarters of declines in gross domestic product (GDP) and are certain to occur from time to time. It's no surprise that when the government requires many businesses to stop operating and most people to stay home, aggregate demand and output will decline substantially.

No recession is the same though many share similar characteristics, such as decreased business activity, increased bankruptcies, and higher unemployment. The Great Recession in 2008-2009 was largely the result of overleveraged households surrounding the real estate bubble, while the one facing us today is the result of a health pandemic that has effectively shut down much of the economy and delivered a demand shock to many businesses.

During this period, companies may experience lower cash flows and tighter liquidity, and unemployment will rise. In response, the Fed and Government are attempting to maintain liquidity in the financial system and provide aid to stabilize the economy during its mandated break.

It's doubtful this scenario made it into any 2020 economic forecasts and rightly so. If every investment or business decision considered the chance of a global pandemic, little activity would take place. Imagine a scenario where a cyber-attack took down the global internet infrastructure for an indefinite amount of time. What would Google, Facebook, or the countless other internet-facing companies look like? That is the equivalent to what the airlines and non-essential brick & mortar retailers are facing with revenues dropping to zero in the blink of an eye.

Significant selloffs are a reminder that anything can happen to market prices in the short-term. Crazy things can occur when there is a price quote minute-by-minute. When managing an investment portfolio, one must be able to survive any scenario in order to succeed. However, during times of easy money and upbeat outlooks, many may attempt to juice returns by using leverage in the form of margin debt or options. That is not something we will ever consider for a stock portfolio even if it might help boost returns over the long run. It reminds us of the quote Howard Marks often cites, "never forget the 6-foot man who drowned crossing the stream that was 5 feet deep on average." By simply managing an unleveraged, long-only stock portfolio, we have the important advantage of ignoring the market when we want to or taking advantage of it when an opportunity presents itself.

Investing versus speculating

About 400 years ago, the first formal stock exchange was established in Amsterdam, which made it far easier to transfer ownership in public companies at the going market price. Everyday people could participate in the compounding machine of the market economy. While this made it easier for more people to share in the prosperity of businesses, the formation of the stock exchange reinforced some of human nature's less desirable qualities, such as: greed, jealousy, herd behavior, and desire to get rich quick by gambling.

The formation of stock exchanges quickly divided participants into two camps: investors and speculators. Investors take ownership in companies to participate in the growth in earnings power and dividends of a company. They view themselves as owners of companies, not renters of stocks. Alternatively, speculators do not care about where the price of a stock is trading relative to its intrinsic value but where they think other people think the price of a stock will be next quarter or year. They price stocks based on their expectations of what they think other people's expectations are likely to be. It's a zero-sum game with few, if any, consistent winners.

The South Sea bubble of 1720 is probably one of the most classic examples of speculation. The South Sea Company was granted a monopoly by the British government to trade with the islands in the "South Sea" and South America. There was no realistic prospect that trade would take place given Britain's involvement in the War of Spanish Succession and Spain and Portugal controlled most of South America. It turned out to be a scheme to persuade people to swap government debt for shares in the company. Officials were incentivized to talk up the share price with salesmen spreading enthusiasm and high expectations for the value of potential trade in the New World, causing a buying frenzy. The stock price increased from about £100 to £1,000 in less than a year, but left many investors ruined when shares quickly cratered back to £100.

Not even Isaac Newton, considered one of the brightest scientists in history, was immune. He participated earlier in the bubble and cashed out with 100% profit as market prices went to what seemed to be unjustified levels in his opinion. However, as prices continued to advance, the pain of not participating in easy profits resulted in him investing what is estimated to be much of his fortune near the peak of the bubble. Upon the subsequent crash, he ended up losing nearly everything. Newton famously said, "he could calculate the motions of the heavenly bodies, but not the madness of people." If one of the smartest people in history isn't immune to these emotions, we do not even want to tempt ourselves by trying to buy things based simply on the belief we know where the price of shares will trade tomorrow.

Speculation is a very crowded game of mass psychology that distorts the investing process and in which even geniuses are susceptible to its deceivingly easy fortunes. It is very easy to give in to these temptations. Once one becomes more and more concerned with where stocks are going to trade next, they are getting farther away from thinking as a business owner and more like a

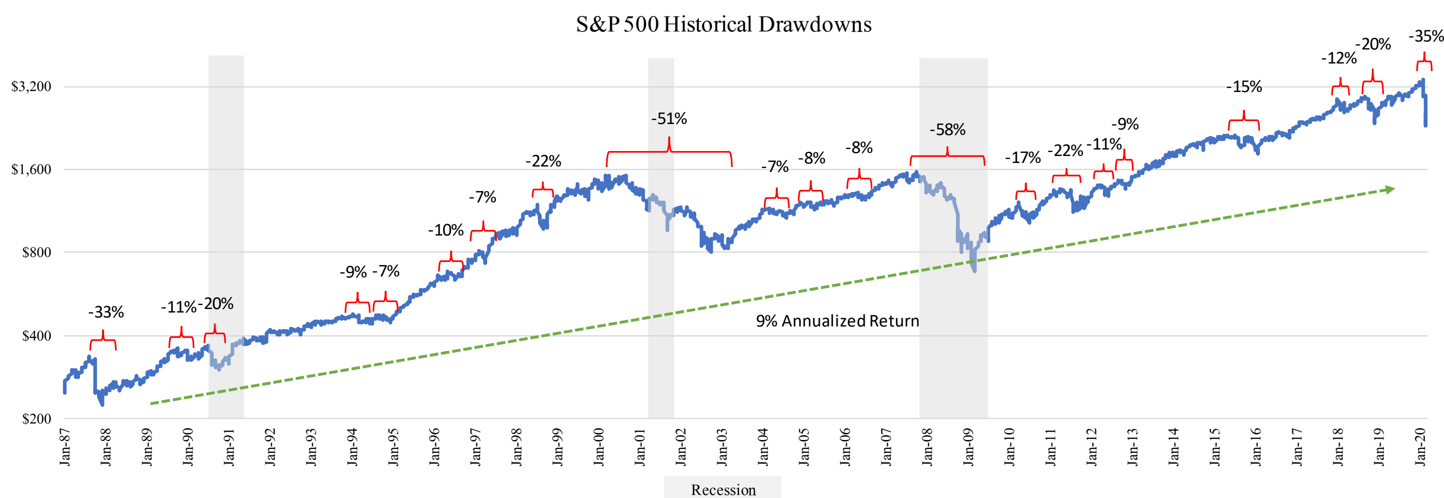
speculator. For the truly long-term investor, all that matters in investing is where the price of shares is trading relative to the intrinsic value of the company, not whether shares will move up or down tomorrow or next week.

Timing the market

Speculation can arise from both euphoria and fear. The biggest mistakes in investing are often not based on what you know or don't know but by how you behave in both good times *and* bad. Given the unprecedented health pandemic and economic lockdown, we understand the feelings of fear and uncertainty one may have. While it may be tempting to react to the frightening headlines by selling stocks in favor of "safer" assets like cash, such a strategy has proven to be deeply flawed historically.

If anything can be learned from studying market history, panics, and recessions, reacting to one's emotions in fear of further price declines in an attempt to wait for the storm to pass is exactly the opposite action that should be taken. The market may continue to be volatile over the near-term with substantial ups and downs. We have no sense in which direction the market may turn over the next twelve months, and that has always been our view.

Below is the chart we provided last quarter showing the S&P 500 Index and historical drawdowns since 1987, now including the recent 35% decline.



Source: Saga Partners, Factset Research Systems

During this period, the S&P 500 has provided a 9% compounded annual return (CAGR) including dividends. This is as good of a result as anyone could have imagined, generating enormous wealth for those who participated, despite including three recessions, likely four if we are currently in one.

Even with the long-term upward trend, the stock market is littered with frequent drawdowns, corrections, and bear markets. There is a 10%+ correction every two years on average, and about half of those will be a 20%+ decline, which have occurred every four to five years. Since these drawdowns occur regularly, people attempt to avoid these declines by buying and selling based when they "feel" a correction is about to happen. Of course average is not a fixed time frame. There can be long periods with little downward movement. Maybe after 2-3 years of strong returns, commentators will start saying we are due for a correction, suggesting investors should move to cash. Perhaps another 2-3 years will pass with strong market returns as one waits on the sidelines trying to control feelings of missing out on easy money, ready to buy back in at the first sign of a down market.

Very few "investors" fully participated in the market's strong long-term performance. Equity fund investors underperform the market by a huge margin. Blackstone produced a report in which they showed that even though the average equity mutual fund in the U.S. averaged 8.2% annually over the last 30 years, investors who invested in these funds averaged only 2%. Another study showed the average equity investor return has underperformed the market by over 4% annually. For those that have attempted to buy in and out of the market by chasing performance or avoiding any setbacks i.e. timing the market, has proven very costly.

It is a big mistake to look at what is going on in the economy today and then decide whether to buy or sell stocks. A bad economy and down market can be your friend if it provides an attractive investment opportunity. It does not make a lot of sense to wait to buy into a great business at an attractive price for the potential that it gets more attractive tomorrow. One should decide whether to buy or sell stocks based on how much they are getting for their money, as in where shares are trading relative to their intrinsic value. The important thing is to have the right long-term outlook.

Volatility is a big advantage to investing in the public markets, but those who become affected by market fluctuations and then make decisions based on them turn it into a disadvantage. If you buy stocks understanding they are susceptible to large price fluctuations, with the expectation they will appreciate over a period of many years, it will likely shield you from any desire to act during market extremes.

Some may argue that as the risks of the pandemic grew more apparent in mid-February the prudent thing would be to sell or hedge one's positions. This same logic could be applied to selling when risks of the Chinese trade war arose, potentially rising interest rates, or the numerous other headline risks that appear frequently. This reasoning also misses the point that one is able to sell near market highs and buy back in at the lows with full clarity.

Maybe there does exist a few talented market timers, better at knowing what people's emotions will be tomorrow than others, though we remain skeptical. Phil Fisher may have said it best, "*I had seen enough of in an out trading, including some done by extremely brilliant people, that I*

knew that being successful three times in a row only made it that much more likely that the fourth time would end in disaster. The risks were considerably more than those involved in purchasing shares in companies I considered promising enough to want to hold them for many years of growth."

We know plenty of people who consider themselves to be long-term investors but will trade in and out of their favorite stocks. To help protect us from these natural human tendencies, we will always be market agnostic. We make our investing decisions not on where we think shares will trade next quarter or year but based on a bottom-up analysis of picking a few of the best returning opportunities we can find.

Portfolio commentary

We typically do not comment on quarterly changes in share prices (both favorable and unfavorable) since short term price swings are largely random, distracting, and can even be misleading. That practice may look convenient given the price of nearly all our holdings fell significantly during the month of March, some even falling by more than 50% at their lows.

A panic, crisis, or recession occurring does not impact how we manage the Saga Portfolio by any means. During a downturn, we do not rotate from low quality companies into higher quality, or cyclical to non-cyclical, or from an out of favor industry into a more favorable industry, etc. At any part of the market cycle, we only own companies that meet our investing criteria with the expectation that we would be happy to own them throughout a downturn.

During such steep selloffs, we must assess if the new market price more accurately reflects a much worse future than previously believed or if it provides a more attractive price at a larger discount to intrinsic value than before. While we obviously do not welcome pandemics, economic declines, terrorist attacks, or any other type of potential harm, it is not unusual that during times of fear and panic certain stocks may fall to prices that provide a very attractive buying opportunity. Last quarter we were able to buy two new companies and reallocate to certain holdings where the price-to-value ratio became much more attractive. It is our expectation that the Portfolio's overall long-term returns will be stronger *because* of the market selloff, but only time will tell.

Companies and their earnings power will be impacted by the pandemic and social distancing measures to varying degrees. Some will be harmed significantly and may not survive, some will see demand decline temporarily as in any recession, and a few will even benefit. The adverse impact to airlines, cruise lines, brick and mortar department stores, and hospitality focused businesses, may be longer-lasting while those related to e-commerce or cloud-based internet services may thrive. Our job is to incorporate the current events that may have a lasting impact

to a company's earnings power and evaluate whether the current price (regardless of where it traded last week, month, or year) looks attractive going forward.

While no one really knows how much the economy will contract or how long this recession will last, it is unlikely that we are about to enter a new world order that will permanently change life as we know it. Eventually some sort of normal will return, people will likely have the same basic wants and needs, and companies will be there to satisfy those needs.

We believe that the companies we own are exceptional, led by high caliber managers, and have strong futures. In many cases they will benefit during a downturn from their strong market position as competitors struggle and they win market share in the inevitable recovery.

Conclusion

When fear and negativity dominate the headlines, an excerpt from Matt Ridley's 2015 book *The Evolution of Everything* seems appropriate to end on a more positive note:

> *"There are two ways to tell the story of the twentieth century. You can describe a series of wars, revolutions, crises, epidemics, financial calamities. Or you can point to the gentle but inexorable rise in the quality of life of almost everybody on the planet: the swelling of income, the conquest of disease, the disappearance of parasites, the retreat of want, the increasing persistence of peace, the lengthening of life, the advances in technology…It is surely gloriously obvious that the world was a much, much better place than it had ever been. Yet read the newspapers and you would think we had lurched from disaster to disaster and faced a future of inevitable further disaster…I could not quite reconcile in my mind this strange juxtaposition of optimism and pessimism. In a world that delivers an endless supply of bad news, people's lives get better and better."*

It is no question the world is facing a significant challenge that it will need to overcome. Despite these challenges, it is optimism that will likely pay dividends over the long-term. This is not some naïve view; it is backed by historical data. Even though future success is never guaranteed, we think a more sanguine future is the probable outcome.

We do not know if we have reached the market bottom, and we never will. We continue to comb through the markets for companies that meet our investing criteria and sometimes a near-term crisis can provide an opportunity for us to reallocate to more attractive opportunities.

We try our best to outline the Saga Portfolio's strategy so investors understand how we think and manage their money. A strong investor base aligned with our philosophy is a true competitive advantage in the investment management business.

We could not be more grateful to our investors for being long-term in their thinking and allowing us to manage the Portfolio to the best of our abilities during any selloffs and more volatile times. None of our investors called during the steepest decline in the history of the stock market in fear or panic, and in fact, a few added to their accounts. We have spoken with several investors in recent weeks who were curious to hear our thoughts on the current situation as everyone is trying to decipher the long-term implications of this dynamic situation. We are always available to answer any questions or to simply catch up.

Sincerely,

Joe Frankenfield

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