



QUARTERLY REPORT

FOURTH QUARTER 2019

4Q19 Results

During the fourth quarter of 2019, the Saga Portfolio (“the Portfolio”) increased 23.9% gross of fees. This compares to the overall increase, including dividends, for the S&P Smallcap 600 Index and S&P 500 Index of 8.2% and 9.1%, respectively.

The cumulative return since inception on January 1, 2017 for the Saga Portfolio is 96.2% gross of fees compared to the S&P Smallcap 600 Index and S&P 500 Index of 27.2% and 53.2%, respectively. The annualized return since inception for the Saga Portfolio is 25.2% gross of fees compared to the S&P Smallcap 600 and S&P 500’s respective 8.4% and 15.3%.

Performance (gross of fees)*				Growth of \$1 Million		
	Saga Portfolio	S&P Smallcap 600	S&P 500			
2017	16.0%	13.2%	21.8%	\$2,000,000		
1Q18	-3.1%	0.6%	-0.8%	\$1,900,000		
2Q18	17.1%	8.8%	3.4%	\$1,800,000		
3Q18	13.0%	4.7%	7.7%	\$1,700,000		
4Q18	-20.4%	-20.1%	-13.5%	\$1,600,000		
2018	2.1%	-8.5%	-4.4%	\$1,500,000		
1Q19	33.6%	11.6%	13.6%	\$1,400,000		
2Q19	11.6%	1.9%	4.3%	\$1,300,000		
3Q19	-10.4%	-0.2%	1.7%	\$1,200,000		
4Q19	23.9%	8.2%	9.1%	\$1,100,000		
2019	65.6%	22.8%	31.5%	\$1,000,000		
Cumulative	96.2%	27.2%	53.2%			
Annualized	25.2%	8.4%	15.3%			

*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 23.7%. S&P Smallcap 600 and S&P 500 performance include dividends.

Source: S&P Dow Jones Indices LLC

Interpretation of Results and Market Commentary

The three-year annualized return of 25.2% (~23.7% net of fees) would rank the Saga Portfolio 77th out of the 7,200 mutual funds currently listed on the Morningstar database or 44th out of all 3,100 equity mutual funds. Unlike many large mutual fund families, we do not follow the common practice of starting multiple portfolio strategies at our inception and then later highlighting the one that performed strongly while disregarding the others with lackluster results. All our successes as well as mistakes are reflected in the results which we will discuss later in the letter.

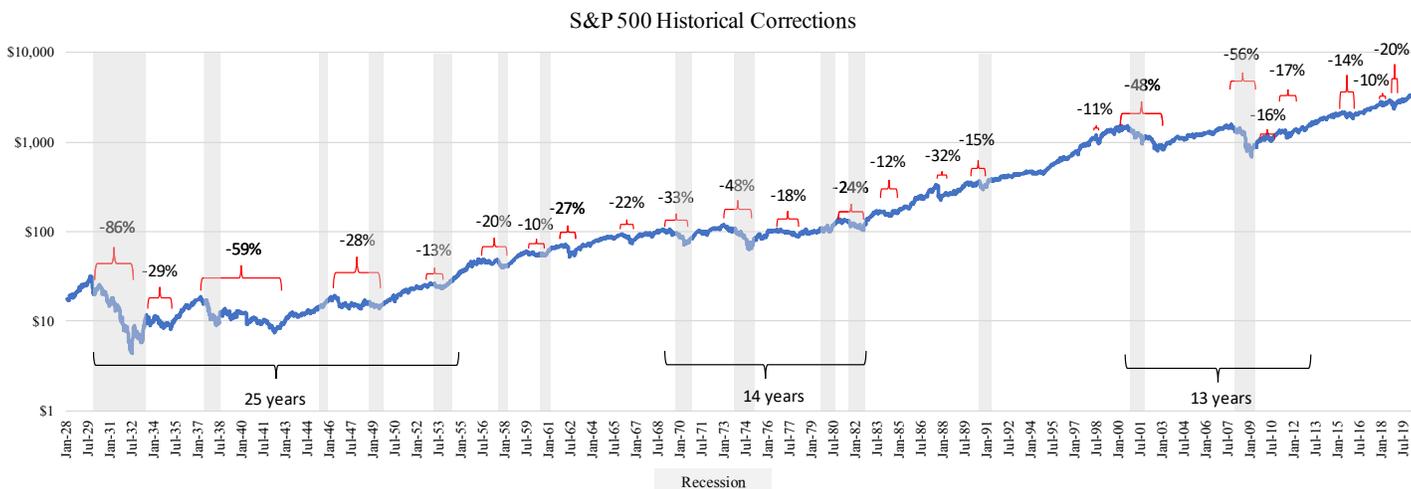
Three years is not “long-term” or statistically significant by any means and any short-term results can be a reflection of skill, luck, or a combination of both. Since it launched at the beginning of 2017, the Portfolio has benefitted from a steadily growing economy and generally rising tide in

the equity markets (a tailwind which has lasted since the summer of 2009). There have been many times over the past decade to have called a market high and then moved into “safer” assets like cash or bonds by trying to time the next market crash. It was only one year ago that commentators were panicking about threats of a U.S. and China trade war, rising interest rates, and fear of being near the end of the business cycle. The economic landscape shifts a lot less than typically believed while sentiment can fluctuate wildly. That is why we believe the best attitude is to be market agnostic. We try to keep our heads down, ignore the noise, and march forward to the best of our abilities since it’s impossible to predict what the market is going to do next.

If one takes the really long-term view, the United States has had an economic tailwind since its beginning. To provide a little history on market behavior, below is a log chart of the S&P 500 since 1928 highlighting each market correction of greater than 10%. While the nearly 100-year trend has been very favorable, we have to live day-to-day, which can cause people to do some pretty strange things.

General skepticism of current market levels is not that surprising. Many investors today have been scarred after going through the dot-com bubble and then housing credit bubble all within a ten-year period. It took 13 years for the S&P 500 to trade above its March 2000 peak, partially reflecting the excesses of the dot-com boom. Of course, thirteen years is nothing compared to the 25 years of market stagnation from 1929 through 1955.

A common saying is “bull markets climb a wall of worry” and that seems to be the case considering the five 10%+ market corrections over the last decade. The irony is that past stock market crashes always look like opportunities, but future ones look like risks.



Source: Factset Research Systems, Inc., Saga Partners LLC

The fear that most market skeptics have while sitting on large cash balances or bonds is that we are at or near a market peak that will inevitably lead to another crash and years of market stagnation from the presumed peak. It’s no question that the market has benefitted from sizeable

fiscal and monetary stimulus in recent years as well as generally declining interest rates over the last 30 years. A reverse in either stimulus or low interest rates would be a headwind to future stock returns. One should likely expect more moderate future returns than the recent past and a significant drop in market values is always a possibility, although we think today's excesses are far from those reached in 1929, 1972, 2000, or 2007.

However, the longer the economy and the market inch along, the louder the “permabears” will shout and eventually they will be right. There is always some reason, risk, or headline for why it isn't a good time to invest. We warn readers before following their advice because: 1. they have no idea when the next downturn will be, 2. if you had followed their advice thus far, it would take a huge decline in asset values to make up for the missed gains, and 3. this can continue to be the case for some time.

We take a generally optimistic view and believe businesses will do well over time and stocks will do well in-kind since their future is tied together. Periodic setbacks will occur but investors in the U.S. have the wind at their back in a game that is stacked in their favor. It can be an expensive mistake to try to dance in and out of the market based upon how the wind is blowing each day or the predictions of “experts.”

Regardless of whether you think you are immune to the emotions of market fluctuations, it really is a bad habit to check the quotes of your stocks every day or even every month. A helpful mental exercise is to imagine you are on a desert island and only receive an update on your companies once a year, at which point you can either buy or sell holdings for only that one day. If this were the case, we think market participants would act much more rationally and be more likely to take advantage of Mr. Market's extremes versus being influenced by them.

Getting back to Saga Partners' results, those who believe 2019 returns can be achieved with any regularity are sure to be disappointed. We can say with confidence that a +66% year is a rare result and partially a subsequent reaction to timing of the steep sell off at the end of 2018.

Of course investors in the Saga Portfolio, both new and old, do not benefit from past results. It is future results that matter. We continue to believe our strategy of buying a few companies with growing competitive advantages, led by great managers, and selling for what we estimate to be attractive prices will achieve above-average performance relative to the general market over the long-term.

There is no doubt the Saga Portfolio will have negative years and perhaps periods of significant underperformance to the general market. Constantly comparing how one's portfolio is performing against the S&P 500, or any benchmark, is likely to distort the investing process. This isn't to say we shouldn't have a measuring stick. We continue to think *at least* a five-year period of

performance compared to the general market is a reasonable time to *begin* to assess an investment strategy, preferably with tests of relative results in both strong and weak markets.

Portfolio Update

The Trade Desk (TTD):



Source: Factset Research Systems, Inc.

Sales and operating income are expected to grow 38% and 3% in 2019. Slower operating income growth reflects increased investments in sales/marketing and infrastructure such as connected TV, data processing, and global expansion.

The Trade Desk’s ad buying platform helps advertisers comb through a huge universe of possible inventory using data to target and value the select inventory that makes sense for that specific advertiser. The Co-founder and Chief Technology Officer Dave Pickles had a good quote when asked about why they started The Trade Desk:

“it just seemed like such an obvious opportunity to go after, if you discover there’s a New York Stock Exchange for ads, the first thing you want to do is build the Goldman Sachs or Bloomberg for ads.”

Buying ads programmatically is significantly more effective than the old Mad Men era approach. Previously, advertisers bought inventory on a trial and error basis using little data, limited targeting, and no price discovery that created a lot of waste. Businesses knew that advertising worked but they didn’t know what they were really buying or which advertising worked best. For example, TV ad campaigns were run based on broad demos on linear TV. There was little detailed feedback on how these campaigns performed. With more viewers now watching TV through connected devices, advertisers are able to better analyze TV campaigns for the first time, significantly increasing effectiveness and the return on ad spend.

The very nature of some types of businesses naturally move toward the overwhelming dominance of one firm. Examples may include internet search, computer operating systems, social media,

payment networks, or in past decades with local newspapers. Competitive dynamics within the demand side platform (DSP) part of the advertising industry share similar qualities.

Economies of scale provide barriers to entry and have accelerated the trend towards consolidation. Advertisers want to come to a single platform to value potential inventory relative to all available options throughout the world. If a DSP can only see half of the available inventory, advertisers will have fewer options, less accurate pricing, and therefore a lower return on investment.

The operating leverage within the business model makes it nearly impossible for smaller players to compete profitably and inevitably leads to consolidation. Every time a DSP looks at potential inventory it costs money whether the customer wins the bid or not. Since DSPs need to look at all available inventory to offer similar value whether it has \$50 million in revenue or \$500 million in revenue, the larger DSP is able to spread similar costs over a greater volume of business. These dynamics create a self-reinforcing flywheel effect; the more inventory available on a platform, the more value provided to advertisers, drawing more advertisers to the platform therefore providing the ability to look at more inventory.

It's the complete opposite dynamic on the other side of the programmatic advertising transaction for supply side platforms (SSPs). SSPs help publishers/content companies monetize their inventory by providing access to demand. The economies of scale on the buy-side do not exist on the sell side. SSPs only have to pay for the traffic they generate creating a more variable cost structure with lower barriers to entry. As the sell side continues to fragment, DSPs have to plug into more and more sources of inventory which further increases operating leverage and raises barriers to entry on the buy side.

Much of the value creation is on the buy side which protects the DSP's earning power/take rate. As DSPs consolidate, SSPs only have to put bid requests out to a few buyers. This means SSPs look at a small fraction of bid queries while the DSP is looking at all available inventory. There is a huge data asymmetry between the buy side and sell side that puts the DSP in the power position when it relates to price discovery. Further, owners of inventory primarily care about getting the highest price for their inventory. Since inventory owners can typically use multiple SSPs to make sure they get the best prices, the SSP offering becomes more commoditized, providing a lower take rate/earning power over time.

Given these dynamics, The Trade Desk continues to look very attractive considering the significant market opportunity. As businesses discover the cost savings and superior ROI in programmatic advertising, it is likely that all advertising will be purchased programmatically one day. As the demand side continues to consolidate and barriers to entry grow, The Trade Desk is currently positioned to be the winning independent demand side platform.

Trupanion, Inc. (TRUP):

Source: Factset Research Systems, Inc.

Note: Adjusted operating income = operating income before any costs to acquire new pets.

Gross profit and adjusted operating income had strong 2019 growth of 26% and 38%, respectively.

Acceptance of pet insurance in the U.S. has historically been low because it was a bad product. It offered little value to customers after considering the extensive fine print in policies that had annual and lifetime limits, exclusions on congenital and hereditary conditions, red tape, and slow reimbursement process. By eliminating the pain points and providing a comprehensive product that is easy to use and understand, establishing veterinarian relationships through its territory partner network, and integrating its software to improve the reimbursement process, Trupanion is set up to continue to succeed in this growing market.

GAAP earnings per share can be a good representation of earnings power for many businesses but that isn't necessarily the case for businesses like Trupanion. Adjusted operating income is a better proxy of Trupanion's performance over time than net income because of significant investments being made in future growth that are expensed at the time they are incurred versus being capitalized over the life of the investment. For example, when a manufacturer buys new equipment to grow its production capacity, the growth capex is depreciated over the life of the equipment. A retailer growing new store locations like Walmart in its earlier day will have high capital expenditures as well. While the manufacturer or Walmart's income statement would reflect accrual earnings, the free cash flow would be much lower as a result of the high capex growth investment.

In Trupanion's business, and in other subscription-type business models where the future cash flows of customers are very predictable over the life of the customer, it makes sense to think of sales and marketing expenses to acquire new customers as growth capex. As in every investing equation it comes down to what cash you lay out today and what stream of cash flows you expect to get back in the future.

One could argue the sales and marketing costs of the manufacturer or Walmart should also be amortized. That would make sense if it were possible to bifurcate which sales and marketing costs were maintenance versus growth, and the value of new customers could be estimated over a multi-year period with some accuracy. However that is not how the economics or customer behavior of those businesses work.

If the average life of an insured pet is six years, every \$1 spent on pet acquisition costs should be amortized over that period, or 17% per year. Assuming Trupanion has 15% operating margins at scale and spends all of it on pet acquisition costs, it makes sense to include 2.5% in amortization expense each year, providing 12.5% earnings before tax margins.

A company would look much less attractive if it was investing heavily in sales and marketing or growth capex but not growing its business, leaving little cash left over for shareholders simply for the business to run in place. Fortunately, Trupanion has been very successful in earning an attractive return on its pet acquisition expenses as reflected by its strong growth.

Linamar Corporation (LIMAF):



Source: Factset Research Systems, Inc.

Sales and operating income are expected to decline a respective 2% and 18% in 2019. Linamar’s end markets have been impacted by softer conditions in the access equipment, automotive, and agriculture segments. Global trade uncertainties and challenging harvest conditions have negatively impacted the agriculture market and the United Automobile Workers strike last fall at General Motors hurt automotive sales in North America. It’s also likely China’s manufacturing

standstill as a result of the coronavirus will weigh on results into the first quarter. Roughly 8.5% of transportation segment sales or <5% of total sales, are generated in the Asia Pacific region.

Linamar is a cyclical business that inevitably ebbs and flows. Demand for higher priced durable goods such as homes, automobiles, or larger capital purchases like farm equipment can decline quickly when consumers and businesses become more uncertain about their future income.

High quality cyclical businesses that are out of favor can provide attractive opportunities. While earnings in any single year may vary substantially, earnings over a full cycle can be more predictable. We are willing to own a great company like Linamar despite what earnings will do in the short term if we believe shares are priced significantly below what they will earn over a full cycle. In past economic downturns Linamar actually benefited at the expense of competitors that went out of business as it picked up takeover business.

2019 was the second consecutive year of global light vehicle volume declines and third year of declines in North America. North American downcycles have typically lasted four years on average. We do not know if auto manufacturing volumes will pick back up in 2020, but considering more difficult industry conditions, Linamar’s 2019 operating results were impressive. If a company can perform well during more challenging times, it is a good sign for what will come once conditions inevitably improve.

Despite current headwinds, management still expects 2019 free cash flow to be between C\$500- C\$700 million, benefitting from lower capex and working capital improvements. This compares to its \$2.8 billion market cap or \$4.7 billion enterprise value. At current levels, shares are selling for a price to earnings of 6x and an enterprise value to expected operating income of 7x.

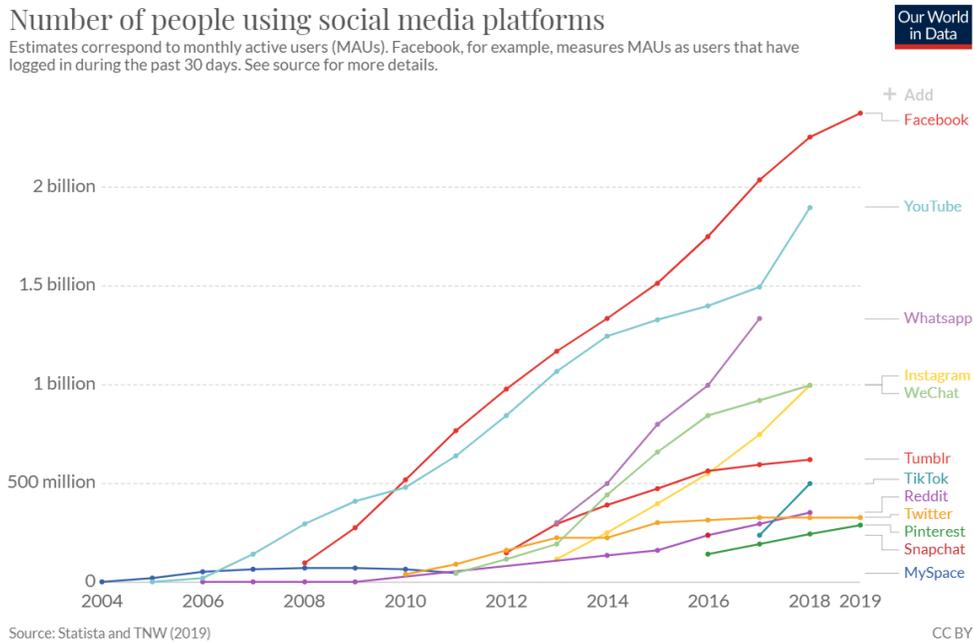
Facebook, Inc. (FB):



Source: Factset Research Systems, Inc.

Sales grew 27% while operating income declined 4% in 2019. As expected, expenses grew faster than sales as a result of increased hiring and investment in safety and security, R&D, infrastructure, and settlements/fines incurred during the year.

Facebook now has 2.9 billion people using Facebook, Instagram, WhatsApp or Messenger each month and around 2.3 billion using one of the services daily, far outpacing other social media companies.



Because Facebook touches so many people around the world in various ways, it has been and will continue to be in the public eye regarding important social issues surrounding free speech and privacy. The company is investing heavily in privacy, particularly with encrypted messaging and richer private social platforms to provide users the ability to engage with friends and groups more naturally. These steps may hurt Facebook’s ability to generate revenue from these interactions, but the goal is to make a better, more natural social experience which will benefit users and therefore the company over the long-term.

At the end of 2019, Facebook was selling for a market cap of \$585 billion. If you back out the \$45 billion of net cash on its balance sheet (netting out the \$5 billion FTC fine that is still payable), its enterprise value was ~\$540 billion. This is only 21.5x its \$25 billion of pretax income in 2019 or 17x its expected \$32 billion of pretax income in 2020. These multiples continue to look very attractive considering the durability of Facebook’s platform, economic qualities, and future potential growth.

LGI Homes (LGIH):

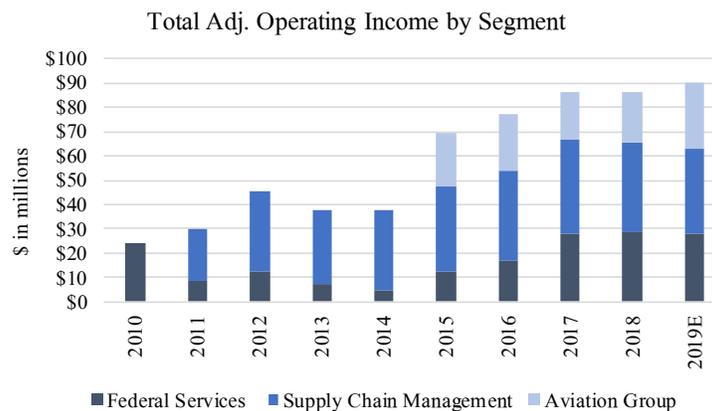


Source: Factset Research Systems, Inc.

Sales and income before taxes are expected to grow a respective 21% and 14% in 2019. Since LGIH went public ~6 years ago, sales have increased 11x, income before taxes by 10x, and home closings by 5x, albeit off a relatively small base. While we expect continued growth, it is sure to be more modest off the current sales of nearly \$2 billion.

LGIH has a business model that has proved successful and difficult to copy within the homebuilding industry. By building standardized, move-in ready homes on lower cost land outside urban areas where potential demand from nearby renters is strong, LGIH is able to turn inventory quickly, keep marketing costs low by going direct to the buyer, and offer quality homes at attractive price points. Homebuilding is a huge and fragmented market and LGIH operates in a special niche where it has a long runway to reinvest capital at very attractive returns, providing a solid runway for continued growth.

VSE Corporation (VSEC):



Source: Factset Research Systems, Inc., Saga Partners LLC

Note: Adjusted operating income = operating income plus dep./amort. less capex.

VSEC’s adjusted operating income is expected to grow in the low single digit range in 2019. Its maintenance capex is much lower than its depreciation and amortization costs that run through

the income statement therefore adjusted operating income is a better reflection of the company's earning power.

VSEC's segments are not especially high-flying organic growers but they are fairly stable, recession resistant, and require little operating capital. Historically the company has used the cash generated from its segments to make acquisitions that complement its core competency in maintenance, repair, and overhaul services. Most recently, the Aviation Group has had strong growth through the recent acquisition of 1st Choice Aerospace. We expect there will be continued focus on growing the Aviation Group with the new CEO, John Cuomo, having a strong background in aerospace distribution. Overall, VSEC has strong, stable cash flow generating ability with modest growth prospects and sells for a very attractive price relative to its earning power (~5x expected 2019 adjusted net earnings and 6x on an EV/EBIT basis).

Carvana (CVNA):

Carvana was a new investment in 2019. It has a very impressive track record as it expands its lead in online used car sales. We wrote an in-depth piece on the company in December which was selected as the large cap winner in SumZero's Top Stocks for 2020 ([link](#)) and was later featured in Barron's ([link](#)).

Dropbox (DBX):

Dropbox was the other addition to the Portfolio during 2019 and has recently become a more full position. We may do an in-depth write-up on the investment thesis soon so will only provide a brief summary.

Dropbox was started in 2007 as an online storage and file sharing platform. It quickly won over consumers with its easy to use interface that provided a simple way to back up files and access them anywhere across a variety of devices. Through viral marketing, Dropbox built its end userbase to over 600 million plus registered users today and was one of the fastest software as a service (SaaS) companies to reach >\$1 billion in revenue.

While Dropbox is perceived to be more of a consumer software company, over 80% of its 14 million paying users primarily use Dropbox for work. Dropbox represents a growing trend among enterprise technology products like Atlassian, Evernote, Slack, and Zoom, where individuals bring software products into the workplace in a bottom up fashion without any formal permission from IT or management.

SaaS businesses have been in the headlines since many of their stocks seem to move higher each day, giving weary spectators flashbacks to the dot-com days. Despite what may be optimistic valuations to say the least, there are many favorable qualities of SaaS businesses such as

predictable recurring subscription-like revenues, significant operating leverage with big upfront costs in research and development but little to no distribution costs which provides scalability and essentially 100% incremental margins for each new subscription. While many SaaS companies are valued today as though they will be the next Microsoft, Salesforce, or Adobe, Dropbox is interestingly valued as though it has little to no future growth or increased profitability despite having what in many cases are industry leading fundamentals.

Dropbox' efficient self-service freemium sales model requires less outbound marketing resulting in lower sales and marketing costs (~25% of sales) compared to many other SaaS businesses where sales and marketing costs can reach to 50%+ of sales. As Dropbox continues to scale, management targets gross profit margins in the high 70% range and operating margins in the low 20% range. The strong gross margins and lower sale and marketing costs have afforded Dropbox the ability to be engineer focused in order to create a great product and user experience.

Although Dropbox is competing against well-capitalized competitors, the company has been successful in growing and developing its more neutral/independent platform which customers often select since Microsoft and Google are perceived to play to their own ecosystem and applications through integration and bundling. Dropbox has developed its product to work with and provide access to its users' content regardless of the program it uses or where it may reside.

How people use and work with their files/content is becoming increasingly important despite simple file cloud storage being more of a commodity service as data storage costs continue to decline. User experience, collaboration tools, productivity features, security, and third-party integrations all work together to create an ecosystem for the growing "smart workspace". Dropbox has evolved into a workflow, team space where "knowledge workers" are able to work and collaborate together where their content lives while being able to use other highly integrated enterprise software tools such as Zoom, Slack, or Atlassian. At an average cost of \$10-\$15 per month per user, the cost of Dropbox is almost trivial compared to how important it is for employees to maintain their workflows. An example of Dropbox' pricing power was its ability to raise prices in their Plus Plan last year by ~20% while its churn rate remained stable in the mid-teens and net revenue retention improved to the mid-90%.

The market expects sales growth to slow materially, however Dropbox will continue to benefit from growing paid users, upselling existing paid users, and continued pricing power. Only 14 million of the total 600 million registered users currently pay. If Dropbox is successful in converting only a small fraction of nonpaying users, it would materially impact sales.

At current market prices, Dropbox has a market cap of \$7.4 billion and ~\$1 billion in net cash, providing an enterprise value of \$6.4 billion. This compares to a free cash flow run rate of \$365 million when accounting for capital leases, shares repurchased for tax withholding, and buildout of the new corporate headquarters. Assuming 2-3% share dilution per year for share based

compensation would provide ~\$350 million in free cash flow, or only 17x enterprise value. Rarely does one find companies growing at a faster rate than the market and such an attractive free cash flow yield. We were very excited to have the opportunity to add this prior SaaS decacorn to our portfolio last year at such attractive prices.

Mistakes, Selling, and Under Armour

The holy grail investment, at least in our opinion, is a tremendously high-quality company with an exceptional management team at a remarkably cheap price. A long runway to grow is a big plus as well. Of course, finding a holy grail investment is rare. Not only are there typically trade-offs between these variables but the evaluation of each factor is subject to interpretation, which is exactly what makes the whole investing process so interesting and fun.

It usually is not very difficult to recognize that some businesses are better than others. What makes investing so difficult is the market attempts to value a business to the point that no longer makes it an attractive investment. Stock prices reflect the market's set of expectations for the underlying company's future performance. In order for a stock to generate excess returns, the company's results have to exceed the expectations embedded in the stock price. At the end of the day, we are trying to form a general range of probable long-term expectations (think 10+ years out) for specific companies and then find situations where the market appears to be significantly underestimating those expectations. Of course, this is very difficult to do for two main reasons.

First, we are working with a very foggy future. No one knows with complete certainty what will happen far into the future, especially as technological innovation appears to disrupt business at an ever-increasing pace. Turnover of companies within the S&P 500 has steadily increased since the 1950s, meaning it continues to be harder to remain among the ranks of the top companies compared to prior generations. Half of all public companies perish within ten years of being publicly listed regardless of its industry. Just because a company was successful in the past does not mean it will be in the future. For most companies, the range of future expectations is so wide that no useful conclusion can be reached. While technological innovation boosts productivity and benefits society as a whole, a changing competitive landscape makes it that much more difficult to form long-term expectations and therefore harder to value companies.

Second, psychological factors impact decision making. Most investors today are aware of these cognitive biases/heuristics. Success in investing is seeing the world as it really is and when everyone else in the world sees it differently, having the conviction to bet against them. Of course it can be challenging to know if your interpretation of facts is always the right one. A good magician can make you see things that are not really there and not see things that are there simply by manipulating how the human brain works.

Everyone has their own perspective or interpretation of the world based on their personal background and how their brain is wired. Interpretations and decision making can even be situation dependent in that different situations can cause different conclusions, even when the same person is thinking about the same subject. There is even a bias from believing you are less biased than others which can really make your head spin. What makes heuristics especially difficult to manage is there can be conflicting biases at play in any given situation.

This all gets back to the topic of making mistakes. Because we are working with a very uncertain future and are susceptible to these numerous and conflicting biases, identifying investing mistakes is not always obvious. It is not perfectly clear if prior decisions were good or bad just because a certain outcome occurred. Good decisions sometimes result in bad outcomes and bad decisions can lead to good outcomes. Was a poor outcome due to bad luck or making a bad decision? Over time, enough good decisions should lead to good results, on average.

There can be a fine line between maintaining conviction in your long-term outlook versus recognizing mounting weaknesses in an investment. In managing the Saga Portfolio, we are likely to be slow in selling an investment that may appear to have cracks in the original thesis just like we are likely to be slow in buying a new opportunity we first come across. This may mean we hold on to an underperforming investment for too long or we miss out on some upside in a stock that increased quickly. We think the benefits of this sloth-like behavior outweigh the costs. It helps reduce the impact of making decisions based on emotions and forces us to think long and hard before committing to any new idea since we intend to own it through what can be both good times and bad.

We like how economist John Keynes recommended viewing, “*the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only.*” Saga Partners prefers a longer courtship to get to know our potential spouse rather than a shotgun wedding that is more likely to end in divorce.

There are really only two reasons why we will sell shares; 1. opportunity costs and 2. mistakes. Opportunity costs are always what is our next best available option. If we find an opportunity that we strongly believe will provide better returns than a current holding in the Portfolio, it would make sense to replace the lower return holding. If the price of a stock appreciates to the point that future returns over the next 10+ years are no longer attractive in our view, we will reallocate that capital to a higher returning opportunity. This may all seem obvious, but it’s important to discuss when considering a long-term investing philosophy, conviction levels, and portfolio allocation.

Sometimes a company’s business strengths are not as strong as we first believed and therefore the long-term outlook is less promising than previously considered. Mistakes are bound to

happen in investing and once we realize a mistake has been made, agonizing over it is a mistake in itself. We actually try to seek out criticism of our ideas whenever possible because we are simply trying to see the world as clearly as possible. It does not matter if we were right or wrong in the past, all that matters is that we try to get as close to right going forward with the information we have available today.

We don't question an investment thesis because shares go up or down and we don't anxiously wait for each company's quarterly report to see if we are right or wrong. If a bad quarter or modest variations in a company's margins and growth rate are going to make or break an investment thesis, it's probably best to pass on to the next idea. However, if material new information comes to contradict part of our original thesis and the company's longer term fundamental operating results seem to be trending far different from our initial expectations, it's in our best interests to reexamine.

Eventually one has to look up at the scoreboard and get results whether that's in an investment portfolio or a specific company. We don't want to be the investment firm that boasts about its superior philosophy, process, and culture, but after a decade of effort have results that leave investors no better off than if they simply invested into the Vanguard S&P 500 ETF yet still try to justify their existence by claiming to have better risk management. While we won't always opine on every mistake we make since there have been and will likely continue to be too many to mention, we like the habit of highlighting the more material ones to help keep us honest.

Under Armour is a company we have owned since starting the Portfolio. It had what we thought were all the ingredients for an attractive long-term investment; a strong brand with a 20+ year track record of solid growth, gaining market share from the industry giants, attractive historic margins and return on capital. The industry appeared to have a long runway for growth with a rising global middle class and performance/athletic apparel becoming increasingly mainstream. It was founder-led by a driven leader who had a significant part of his net worth in company stock.

After shares reached euphoric highs of over \$50 per share, a perfect storm of events, both self-inflicted and some industry-wide, led to the stock cratering and us subsequently picking up shares at an average price of around \$20 a share. Retail bankruptcies, high inventory levels, overexpansion and aggressive sales practices, and a few questionable technology acquisitions left the company needing to slow down and refocus. What we anticipated to be a transition period with slower sales growth and reigning in a cost structure built for a larger company proved to be more pervasive. Competition intensified, fashion trends shifted, and executive management faced turnover as the company tried to regain its footing.

Of the various types of moats, we have realized brands are more challenging for us to assess. An important component of our original thesis was that Under Armour is a durable sports brand and

globally desired sports brands are difficult to build. Despite having large and well-established competitors like Nike and Adidas, Under Armour was able to compete successfully for years. We believed consumers would continue to pay a premium to wear Under Armour shirts, shoes, and other products. As they were competing with other high-quality sports brands who wanted to sell at premium price points, we believed there would be little price competition. Despite this view, Under Armour's rapid overexpansion and potentially overextended product lines may have hurt their brand more than we believed. Customers appear to have grown accustomed to the off channel discounted inventory while the company has struggled to sell product at its premium price points.

The internet has also really shifted the competitive landscape in many industries and lowered barriers to entry. Specifically with consumer products, smaller companies can now more easily reach customers and compete with the larger well-established brands. E-commerce and access to distribution (thanks to Fulfillment By Amazon and Shopify Fulfillment Network) and social media with targeted digital advertising (think Google, Facebook, and The Trade Desk...at least we got something right!) have made it increasingly easier for the Dollar Shave Clubs to compete with the Gillettes of the world.

We have realized that brands are more susceptible to disruption than we previously believed and when there is an element of fashion trends tied to its success, we have little to bring to the table. Weighing the various factors and our revised long-term outlook for Under Armour, we have decided to sell the last of what has become a relatively small position in the Portfolio.

We may be wrong in our revised outlook. It wasn't too long ago Adidas went through a period of slower growth (2013-2016) and subsequently introduced popular new products combined with improved advertising spend that led to strong sales and profitability trends. Perhaps Lululemon's brand has durable pricing power and the market's strong growth expectations will be realized, supporting its \$35 billion market cap on ~\$4 billion in sales and ~\$900 million in operating income.

Many companies in this category will have very bright futures but we have less confidence in our ability to predict these trends. These questions now go into our "too hard" bucket. We are obviously still rooting for Under Armour and maintain the view the company will work through its issues and likely be selling a lot more shirts and shoes in ten years from now. However, when we look over the investing landscape at other potentially attractive opportunities, it's best to reallocate capital accordingly.

Under Armour has been our biggest realized loss to date at slightly less than 2% of the total portfolio. The opportunity cost is much more when considering what the capital allocated to Under Armour would have done in some of our other more successful investments, but all we can

do is learn and keeping marching forward. We are sure to make more mistakes but we will try our hardest to keep the unforced errors as low as possible.

Conclusion

The purpose of these letters is to help our investors understand what they own and how the Portfolio is managed. As much as we love to dive deep into our investing philosophy and process each quarter, we think our past letters provide a good framework for understanding how we think and what we are trying to do. Going forward we will be providing semi-annual letters with portfolio updates and any other notes we think may be important. This will let us spend even more time searching the investing universe for great ideas, managing the Portfolio, and put less emphasis on short-term quarterly results. We will still send out an updated factsheet each quarter and write periodic research notes that will be posted on our website at www.sagapartners.com.

We are also looking forward to hosting our third annual investor meeting in August/September this year. These meetings are the best opportunity for us to speak directly with our investors. More details will be sent out in a few months and we hope to see you there!

As we look into the fourth year of managing the Saga Portfolio, we couldn't be happier with the investors that have joined our growing group. We continue to be 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. We would love to continue to grow with like-minded investors. If you know someone that may potentially be interested in the Saga Portfolio, feel free to forward on our information. The next date the Saga Portfolio will accept new investors is April 1, 2020. As always, please reach out if you have any questions or comments, we are always happy to hear from you!

Sincerely,

Joe Frankenfield, CFA

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Saga Partners LLC is an independent, fee-only, registered investment advisory firm, providing portfolio management to individuals, retirement plans and institutional investors.

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