



QUARTERLY REPORT

SECOND QUARTER 2019

Annual Meeting & General Update

We're excited to host our second annual meeting on Saturday, August 24. We think this is the best opportunity for us to speak directly with our investors and for you to better understand how your money is being managed. More details will be sent out soon and we hope to see you there!

As we approach our third year since launching the Saga Portfolio, we have been privileged to grow with a great group of investors that align with our philosophy. We have expanded outside past our original group that largely consisted of close family and friends. The minimum investment for new accounts remains \$100,000. The minimum exists largely because managing many smaller accounts can eventually become burdensome. Several individuals have approached us with interest in investing but may not have had exactly \$100,000 when rolling over an old IRA or brokerage account.

We understand people in their 20s, 30s, or 40s, may be earlier in their careers and have smaller total funds to invest than some more established investors. We like investing money for people who really align with our philosophy and typically do not have access to investment strategies like the Saga Portfolio. Hedge funds require accredited investors while Saga Partners does not have that limitation since we are structured as a registered investment advisor. There are fewer good investing options for non-accredited investors outside passive index funds. Later in the letter we go into more detail about the many pitfalls of actively managed portfolios, particularly within the mutual fund industry.

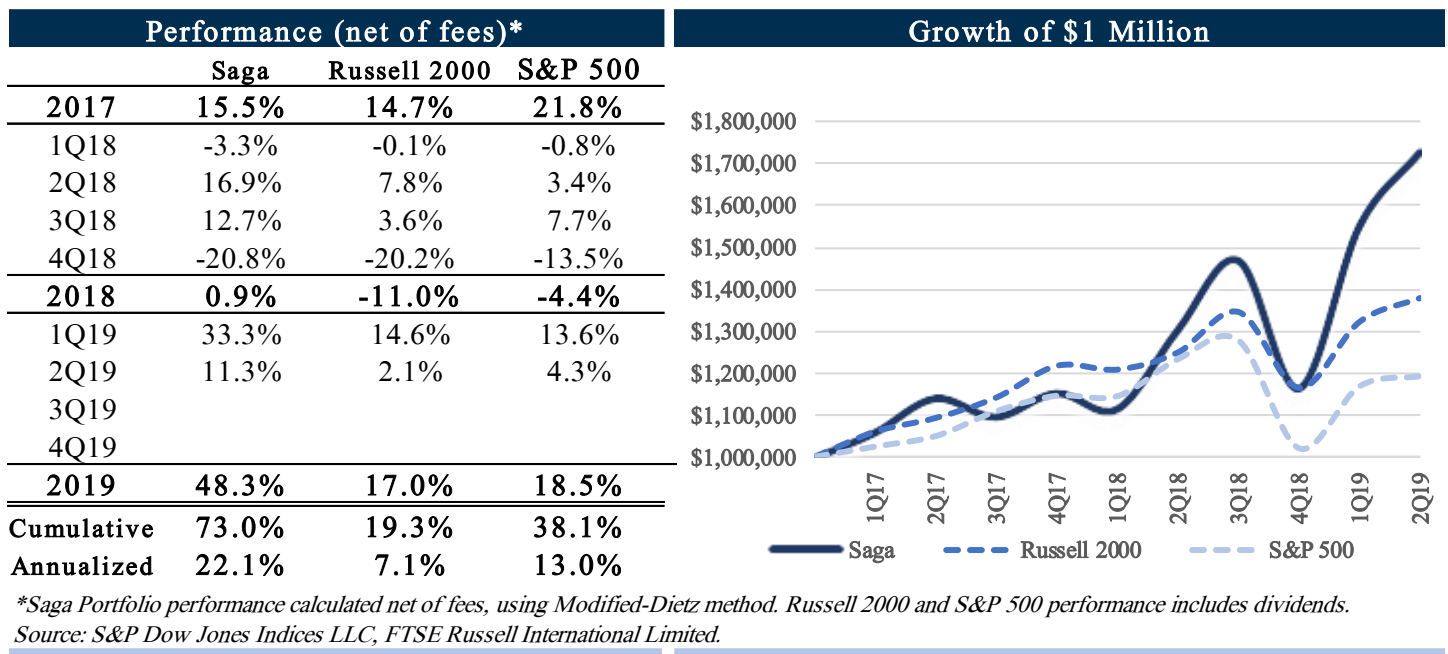
At this point we are still small enough that it can make sense to take on smaller new accounts with the expectation we are starting a long-term relationship that will last for many years to come. We can make exceptions on the minimum initial investment on a case by case basis if it makes sense to do so.

To help simplify our "back office" operations, we will only accept new accounts at the beginning of each quarter, with the next date being October 1. As a two-man shop, Mike and I have to wear many different hats and this will help streamline the onboarding process for new clients. We are always trying to simplify any administrative processes so we can spend as much of our time wearing our most important hat as Portfolio Manager. Existing investors can continue to contribute money as they wish.

2Q19 Results

During the second quarter of 2019, the Saga Portfolio (“the Portfolio”) increased 11.3% net of fees. This compares to the overall increase, including dividends, for the Russell 2000 and S&P 500 Index of 2.1% and 4.3%, respectively.

The cumulative return since inception on January 1, 2017 for the Saga Portfolio is 73.0% net of fees compared to the Russell 2000 Index and the S&P 500 of 19.3% and 38.1%, respectively. The compounded annual return since inception for the Saga Portfolio is 22.1% net of fees compared to the Russell 2000 and S&P 500’s respective 7.1% and 13.0%.



Interpretation of results

Do not read too much into the Portfolio’s performance over the last six months or try to extrapolate those returns far into the future. Quarterly, and even annual results can be almost as random as monthly or daily performance. Even a short two-and-a-half-year track record of outperformance does not guarantee future outperformance. It could be attributable to luck, skill, or a mixture of both.

We have spoken with many investors recently who are very focused on what the market and economy are going to do. There are concerns we are in the longest economic recovery in history and therefore potentially near the end of a business cycle while the market is trading near all-time highs. Many fear an imminent crash is right around the corner. From our experience we have only known two types of investors: those who can’t time the market, and those who do not know they can’t time the market. It’s truly astonishing the amount of effort that goes into trying to predict

the unpredictable and how many believe in their ability to explain the unexplainable ...with the help of hindsight of course.

Last quarter we briefly spoke about the normal cognitive bias of loss aversion. It is human nature to fear losing what you already have. The idea of seeing one's savings decline by 10%, 20%, or even 37% like it did during 2008, is so painful that it feels better to stay in safer assets such as cash and bonds. While the 37% lost in 2008 scarred many investors, the +27% return in 2009, or +32% in 2013, or +22% in 2017 seem to have made less of an impression. What has been the total cost to investors trying to time the next market crash? It's very likely that the unearned gains for investors that moved to cash and bonds out of fear of the next market dip far outweigh any losses during a single downturn.

We fully expect to be managing the Saga Portfolio over many more years and hopefully decades if health permits. Inevitably we will go through multiple downturns, crashes, and any of the other strange things that can occur in the public markets. Instead of trying to predict when these unforeseeable events will occur, we claim ignorance. Our attitude is to be market agnostic since we do not believe we can predict it or position ourselves effectively to avoid it without lowering long-term expected returns. We spend little time worrying about macro-economic trends and even less time trying to apply predictions to them in order to manage the Portfolio.

Not only will we go through times of market chaos, we welcome them with open arms. During such times, asset valuations will also likely contract when optimism is less prevalent and fear takes over. During times of higher volatility, some companies move much more than others, potentially offering a specific investment at a much larger discount than before, providing the opportunity to reallocate part of the Portfolio from one idea we think is undervalued to another we think is even more undervalued.

This is precisely what we did at the end of last year. Your returns would be lower today if we never went through the market correction during the fourth quarter of 2018. You may not have felt that at the time when your brokerage statement was down from the prior month, but we were able to reallocate the portfolio to companies that sold off to a much greater degree than others.

We can only hope that we go through another and even more severe sell off. Those events are when the best opportunities present themselves. We had no idea that the market would recover so quickly, we simply knew that we could allocate the Portfolio to much more attractive opportunities during the sell off, therefore improving future returns.

As we state in each letter, we do not seek to outperform in every reporting period or in all market conditions, rather we seek to outperform the market and other funds over longer periods of time. This is a marathon, not a sprint. It is inevitable that any successful investment strategy will underperform, potentially for several years at a time.

However, after a certain amount of time has passed, it is your right to start looking at the scoreboard to see how well we are playing the game. 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.

Diversification & Allocation

To a certain extent, our better than average performance can be attributable to significant outperformance by just a few of our larger positions. That is bound to happen in a portfolio of only a few carefully chosen stocks. Any big swings in a larger position will have a material impact to the Portfolio's overall results over the short-term.

The Saga Portfolio follows a diversification policy much different than that of nearly all large public equity investment portfolios. Historically, our top five positions have averaged 60-80% of the total portfolio. This sort of concentration is certain to produce wide swings in short-term performance, some most certainly unpleasant. This is one reason why we think short-term reporting can be distracting and even misleading.

It would be much more preferable to report that our results represented 50 uncorrelated securities in 10 different industries, all of which have the risk-adjusted expected returns of beating the market by 10% per year. Then we could put 2% of the Portfolio into each of the positions with a high degree of certainty that the Portfolio in total would beat the market by about 10% each year.

Unfortunately, investing doesn't work that way. We simply do not have that many good ideas. We must work extremely hard to find just a few attractive ideas in which we have a high level of conviction on. For the few we do find, our expectations may vary meaningfully. The question is always how much to allocate to our #1 idea and how much to allocate to #8, #9, #10 and so on, remembering there is only 100% in every unleveraged portfolio.

Allocation depends on the expected return for the #1 idea versus the #10 idea. It also depends on the total expected range of potential returns of a specific security. Two securities could have the same expected returns, but the range of expected returns affects its attractiveness. For example, if a stock had an expected annual return of 15% over the next 10 years (not compounded) and the 10-year U.S. treasury was yielding 15% (far from today's actual yields) the treasury would look relatively more attractive given its certainty. The much wider range of potential returns for the stock, particularly on the downside, lowers the benefit of concentrating in it.

While the above explanation may sound very scientific...it isn't. We are always working with a foggy future with infinite interrelated variables and potential outcomes. The job of a portfolio manager is weighing future probabilities using sound facts and judgement in order to reach certain

expectations. Only after years of making many investing decisions can one get an idea how accurate their previous calculations were.

One thing is for certain: if the goal of investing in an actively managed portfolio is to beat the market by a decent margin, any portfolio holding 100+ different stocks is simply not going to make the cut. The addition of the 100th stock simply can't lower the potential variance in the portfolio performance enough to compensate for the negative effect its addition has on the overall return expectations. Anyone owning such a large number of securities after presumably studying their investment value is not following basic math principles.

We looked at the historical performance of all U.S.-focused equity mutual funds listed on Morningstar with a 10-year track record and over \$1 billion under management. There were roughly 500 in total representing just under \$4 trillion in assets. Over the last decade only ~35% of them beat the S&P 500's annual return of 14%. Over the last 15-years only ~30% beat the S&P 500's 9% annual return. Interestingly, about 75% of the mutual funds were within +/-2% of S&P 500's annual return and nearly all the funds that outperformed only beat the S&P 500 by a few percentage points a year. The data does not even include all the funds that shut down during this time. The S&P Global 2018 SPIVA report states only 5%-10% of mutual funds actually outperformed over the last 10-15-year period.

At Saga Partners we like to think of ourselves as taking the long-term view, but hopefully after 10-years, and definitely after 15 years' worth of blood, sweat, and tears trying to outperform the market, we have a little something to show for our efforts. It's no wonder the old guard of active management is losing assets while passive investing is booming. Why would anyone want to pay for a bad product or service when a pretty satisfactory one is essentially free?

Our style is unconventional to say the least. We are willing to concentrate fairly heavily in what we believe to be the best investment opportunities, understanding that this may cause an occasional bad year or two which might not be the case if we were more diversified. We are willing to go up to 40% allocation in a single position, but only in very rare situations. This rarity is what makes it necessary that we concentrate so heavily when such an opportunity presents itself.

At the end of the second quarter, The Trade Desk comprised ~30% of the Portfolio. A 30% allocation to a single position is a large and rather rare position size in the Portfolio. This has been the only idea since starting the Saga Portfolio that has even exceeded a 15% allocation, and only five other investments have exceeded 10%.

Any situations that permit such a concentration must promise significantly superior performance relative to the market compared to other opportunities at the time. They must also possess such

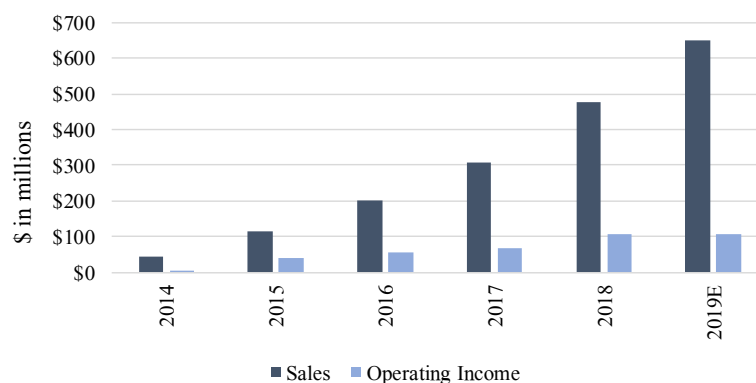
superior qualitative and/or quantitative factors that the chance of serious permanent loss is minimal, while understanding that anything can happen on a short-term quotational basis.

Investors in the Saga Portfolio are willing to trade the pains of short-term variance in order to achieve better overall long-term performance. We could manage the Portfolio in such a way to reduce volatility, but we would also have to reduce our overall performance. This policy typically results in limited trading activity when we feel strongly about the relative quality of our largest holdings. We think it's more prudent to focus on a few investments we understand very well. Fortunately, activity is not what creates strong returns; good ideas are.

Portfolio Update

The historical sales and operating income of the Portfolio's top five holdings are provided below. These numbers mean little in isolation. Quantitative figures are like a scoreboard during a game. Qualitative factors are more interesting to watch. We like to focus on how well the team on the field is performing rather than staring blankly at the scoreboard. How good is the coach, do the individual players work well together, do they have a winning culture, how do they handle upsets? Over time, these factors that happen on the field should inevitably lead to a strong output, i.e. a winning record and *cash flow*.

Trade Desk, Inc. (TTD):



Source: Factset Research Systems, Inc.

Sales and operating income both grew 55% in 2018 and are expected to grow a respective 36% and 0% in 2019. Flat operating income this year reflects continued investment in infrastructure such as connected TV, data processing, and global expansion. Somewhat counterintuitively, the lower the operating income, the better the results. The Trade Desk has historically been able to reinvest in areas that have driven its market dominance and propel growth. The more areas it is able to reinvest cash flow at high rates of return, the better future results will likely be, i.e. the lower the earnings today, the higher the future cash flows will likely be.

The Trade Desk is truly an exceptional company. Its platform helps advertisers comb through a huge universe of possible ad inventory to target and value the token few that make sense for that specific advertiser. It is very rare to come across a company that has high and growing barriers to entry, economies of scale, network effects, and compounding demand. The cherry on top is that it is founder-led with management owning a significant number of shares that make up nearly their entire net worth.

When we analyze the competitive dynamics of a company, we look at both the demand and supply of the industry. Many investors tend to focus much of their time on the demand side, such as what revenues will be over the next few years. Fewer analysts consider the supply side, which is often what provides insight to any barriers to entry and therefore potentially favorable or unfavorable long-term economics. With The Trade Desk, there are very favorable dynamics on both the demand and supply side of the equation.

On the demand side, a company's total addressable market, or TAM, is a phrase that gets thrown around a lot, particularly in the technology space. It should typically be taken with a grain of salt when analyzing a company's future prospects. However, The Trade Desk operates in a huge and growing potential market. Essentially all global advertising spend could be a potential customer. Companies are increasingly realizing that buying advertising space in a programmatic, data-driven way improves their return on ad spend and grows their business more effectively. The programmatic advertising space is currently growing at about 20% a year and The Trade Desk is growing at roughly twice that rate.

On the supply side, the industry is consolidating. Increasing economies of scale are forcing smaller demand side platforms (DSPs) to either get acquired or go out of business. A new start up DSP will not have the cost structure or ability to compete with the already established players.

Google, Facebook, Verizon, AT&T, and Adobe are some of the companies that offer similar competing demand side platforms. One disadvantage of these DSPs is their core businesses are largely monetizing their media content. They are less focused on trying to buy inventory for advertisers and more concerned with selling its own inventory to advertisers for the highest possible price. There is an inherent conflict of interest when advertisers use Google's DSP that Google prefers an advertiser to spend more money on google.com or youtube.com instead of at a competing website. This is one reason it is likely there will be at least one independent DSP as the industry matures.

Additionally, there are transparency benefits in having a single demand side platform. Companies advertising want to come to a single place to have the ability to value inventory relative to all available options throughout the world. This makes it possible to purchase inventory at the fairest price for a specific advertiser trying to reach a specific end-market. The more inventory sold over a platform, the more value an advertiser receives, attracting more advertisers to the platform, and

therefore attracting more inventory to sell to those advertisers. This increasingly looks like a winner-take-all dynamic and The Trade Desk has established itself as the dominant independent demand side platform.

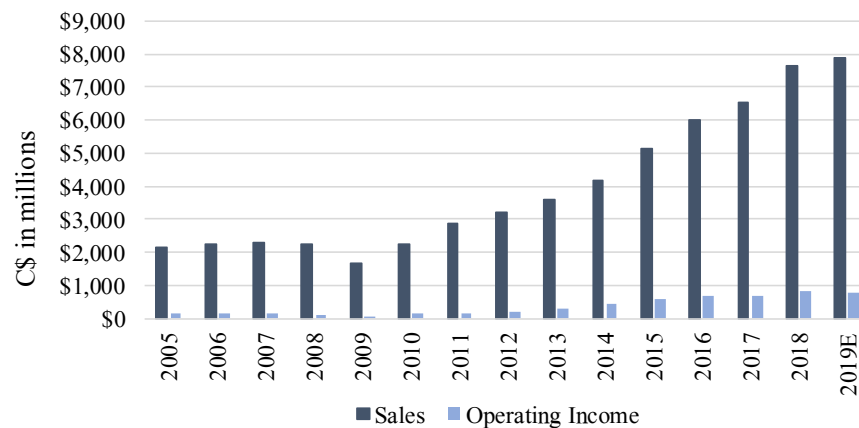
Of course when our investors see their shares trading at 5x their original cost basis, a fair question to ask is “how can this company still be undervalued”? It’s also not uncommon for “value investors” to look at The Trade Desk’s current multiples and quickly look the other way.

We discussed platform companies in our 4Q18 letter when we stated:

“The highly scalable unit economics, when combined with the self-reinforcing network effects, make it theoretically possible for a platform company to expand to the total size of the market. This creates a winner take all dynamic and makes it possible for a single business to gain a majority market share as an industry matures. A platform monetizes by capturing a portion of the value it creates. As value grows, so does earning power. Profit margins improve drastically as a platform grows to dominate a market. This does not occur because a platform is raising prices or gouging suppliers the way a traditional linear monopoly might, but because the overall value the platform creates grows exponentially.”

While many might lump The Trade Desk with the other high flying and seemingly overvalued SaaS technology companies, when we look 10 years down the road, The Trade Desk will be valued at a significantly higher valuation than the ~\$10 billion market cap it had at the end of the second quarter.

The Trade Desk’s flywheel is starting to spin faster and it’s becoming more apparent that it will be the winning platform in this very large space. It has the ability to grow at scale while requiring relatively nominal incremental invested capital. When you find an opportunity such as this, the best thing to do is back up the truck. Any single year’s performance of the stock can be quite erratic, but we continue to believe the probabilities are highly favorable for superior future performance over a multi-year period. Really good things tend to happen for a company that has huge/growing demand and limited/declining competition.

Linamar Corporation (LIMAF):

Source: Factset Research Systems, Inc.

Sales and operating income grew a respective 16% and 15% in 2018 and are expected to grow a respective 3% and decline 1% in 2019.

People often ask how we find investment ideas and our answer is fairly vague...we read a lot; industry publications, papers, other investor letters, books, etc. We came about Linamar in early 2017 after reading a Barron's article on the company. The article sparked enough interest for us to take a closer look. After diving deeper into the auto-OEM sector, Linamar continued to stick out amongst peers. The more we learned about the company, the more impressed we became.

Culture is one of the most important qualitative characteristics to understand when considering a company. Is it a culture to win, create value, provide a great product or service? A strong well-engrained culture is likely to endure. Once we dug into Linamar it became apparent that the company and its culture checked all our boxes and more.

For those interested in learning more about one of your Portfolio companies and a great business story, we recommend reading *Driven to Succeed, How Frank Hasenfratz Grew Linamar From Guelph to Global*. It begins with how Frank Hasenfratz escaped during the Soviet invasion of Hungary and arrived in Canada as a refugee during the 1950s. He did not speak English or French and spent two weeks sleeping at a train station while washing cars for twenty-five cents. He finally saved enough money to travel to Guelph, a city west of Toronto, to connect with an uncle he never met and start a new life.

Frank used his technical skills as a machinist that he learned from an apprenticeship in Hungary to start a business from his basement, eventually growing it into the global auto-OEM we own today. His daughter Linda took over as CEO in 2002, managing the Company through the worst auto downturn in history, and successfully growing Linamar to the \$8 billion in revenue and \$800 million in operating income earned in 2018. Management thinks long-term about growing the

business and is aligned with shareholders with the Hasenfratz family owning one third of outstanding shares.

Linamar prides itself on doing pretty common things, uncommonly well. The Company is relentless about keeping costs low through process efficiency and product innovation. Even as Linamar has grown into an international company, it continues to retain its entrepreneurial culture that has made it so successful with each one of its 60 plant managers fully in charge of their own facility.

Over the last thirty years auto manufacturers realized they can achieve better and more cost-effective results by outsourcing key functions. They began by outsourcing low-value parts, then moved to seating, instrument panels, and bumpers. The powertrain is the last area of the vehicle to be outsourced precisely because it is so important to the consumer. New contracts for engines, transmissions, and the driveline are progressively being offered, directly benefitting Linamar as one of the global trusted suppliers.

Despite Linamar's advantages, it operates in a cyclical industry. During recessions, demand for higher priced durable goods such as homes and automobiles can decline quickly when consumers become more uncertain about their future employment and income. While Linamar's short-term earnings may be temporarily impacted by a quick decline in demand, it has historically and will likely continue to be able to grow throughout a full business cycle.

During 2008 when auto unit production fell nearly 40% over a relatively short period, several smaller competitors went out of business, which led to many opportunities for Linamar. In 2009 the company received significant takeover business which were orders that customers needed on an urgent basis because their previous supplier was suddenly no longer able to fulfill a contract. Some of Linamar's customers said they were the 9-1-1 of the automotive industry since they could count on them in times of need.

It is also worth mentioning that the ~40% decline in U.S. auto production during the Great Recession was an unusually large drop. The next largest decline was in 2001 when the SAAR U.S. auto units declined 11% while Linamar's sales actually grew 7%. In 1996 when unit production fell 6%, sales grew 11% and in 1991 when unit production fell 2%, sales grew 33%, albeit from a much smaller base than today.

A couple excerpts from the book stood out to us. From the quotations below, it is apparent that the culture is exactly what we are looking for in a company:

Frank Hasenfratz quoted, "We developed a few numbers and rules years ago that came from my family. Never spend more than what you have. Or never spend more than you know you're able to pay for. Never borrow more money than one year's cash you're generating.

For every dollar of sales, Linamar aims to make a profit margin of 7% and a 20% return on shareholder equity. We don't want to be rigid, we can deviate from those numbers, but you need to show me how you're going to get a return on shareholder's equity. You want to have rules, but you also need some flexibility because two and two isn't always four. Sometimes it's five; sometimes it's three. Learn from the past, but look ahead."

Frank Hasenfratz quoted, "If you're going to do everything the way the book tells you, you're just another company. You can make a living, but that's not the idea – just to make a living. The idea is to create something. You have a lot of people and if you want to keep the good people, you have to grow so you can promote them. If you cannot promote them, they're going to leave you. As a result, we grow at an average of 15% a year compounded so we can keep our good people and let them help us keep growing."

"Customers are so trusting of Linamar's production systems and quality control that the company's output goes directly to the assembly line at Ford, GM, or Chrysler without further scrutiny by the customer."

"Linamar's secret? Paying attention to three basics. Balance between advanced manufacturing technology, financial probity, and a stable, flexible workforce that also happens to be non-union."

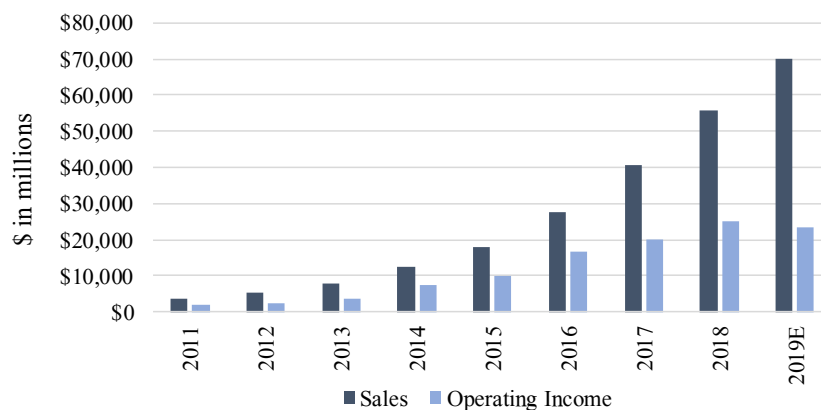
The book and those quotes were published over seven years ago. Since 2012, Linamar's sales have grown at a 15% compounded annual growth rate (CAGR), operating income at a 22% CAGR, and earnings per share at a 27% CAGR. While Linamar has been operating with the wind at its back during a modest auto recovery, North American light vehicle production has only grown at a 4% CAGR and global light vehicle production has grown at a 2% CAGR. Linamar's relative results show how it is able to grow despite lackluster auto unit production by increasing dollar content per vehicle. The Company has also moved into new end-markets within its industrial segment where it can reapply its expertise in precision machining of components.

While shares are selling ~25% below our initial purchase price, its fundamentals remain strong. Sales have grown 30% and operating income grew 16% during our holding period. While management only expects mid-single digit sales and operating income growth in 2019, free cash flow is expected to be between C\$500 - C\$700 million compared to the current \$2.8 billion market cap or \$4.9 billion enterprise value. Free cash flow is expected to largely go towards debt

used from the MacDon and Montupet acquisitions, providing an expected net debt to EBITDA of ~1.0x by the end of 2019.

At current prices, shares are selling for a price to earnings of 5x and an enterprise value to expected operating income of 6x. While we do not know if another recession is around the corner, we think Linamar looks very attractive at current prices despite any potential macro downturn.

Facebook, Inc. (FB):



Source: Factset Research Systems, Inc.

Sales and operating income grew a respective 37% and 23% in 2018 and are expected to grow a respective 26% and decline 7% in 2019. Lower operating income is expected as a result of increased investment in safety and security, innovations, and infrastructure.

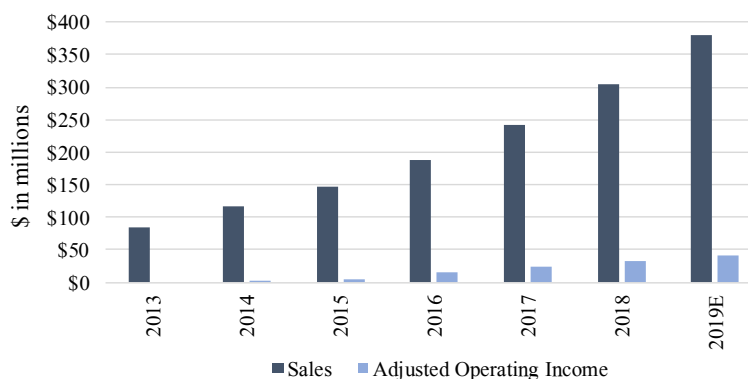
Of our five largest holdings, we have owned Facebook the shortest time. We wrote about our initial investment and thesis during our 4Q18 investor letter so we will just briefly touch on the general Facebook opportunity.

Facebook is probably the best known and most followed investment in the Saga Portfolio and by far the largest in terms of market cap and sales. Some have commented to us that Facebook is a no brainer investment. This brings up the question, why should our investors pay us to invest in Facebook when they could just do it themselves? Believe us when we say that public opinion and consensus views on Facebook's investment value varies widely.

However, even if Facebook was such an obviously attractive investment, we have no biases against the "no brainer" ideas. In fact, that's exactly what we are looking for. There are no extra points for degree of difficulty in investing. It is not our goal to impress observers by our undiscovered obscure ideas or superior intellect. Our goal is to provide market beating investment returns over the long-term. If that means buying a high-quality company with strong growth prospects at an attractive valuation, that's exactly what we will do.

Last year presented a rare opportunity to buy into one of the highest quality companies available at a significant discount. While shares have quickly recovered from the market lows, Facebook still offers very attractive expected returns from current prices. At the end of the quarter, Facebook was selling for a market cap of \$550 billion. If you back out the \$40 billion of net cash on its balance sheet, its enterprise value was ~\$510 billion. This is only 22x its expected \$23 billion of operating income in 2019 or 16x its expected \$32 billion of operating income in 2020. These multiples continue to look very attractive considering the durability of Facebook’s platform and its growth potential.

Trupanion, Inc. (TRUP):



Source: Factset Research Systems, Inc.

Sales and adjusted operating income grew a respective 25% and 36% in 2018 and are expected to grow a respective 25% and 31% in 2019. We shared our Trupanion write up in last quarter’s letter which outlined our investment thesis in more detail.

Every year the CEO writes one of the most detailed and transparent annual letters we have come across from a public company. He lays out his long-term goals, what the company is doing well, and what the company can improve upon. Trupanion has been a publicly traded company for five years and we now have five annual letters to go back and track what the CEO has said and then compare to what happened and the results are more than impressive. If only all CEOs followed suit!

From the beginning of the 2018 annual report;

“This letter is being published a few months shy of our five-year anniversary as a public company. Looking ahead to the next five to ten years, our annual goal is to grow revenue 20% to 30%, achieve and maintain an adjusted operating margin of 15% of revenue, and reinvest as much of it as possible while achieving an anticipated internal rate of return between 30% and 40% for a single average pet. If we can achieve these three goals on an

annual basis while continuing to build moats around our business and maintaining our culture, we will have had a good year.”

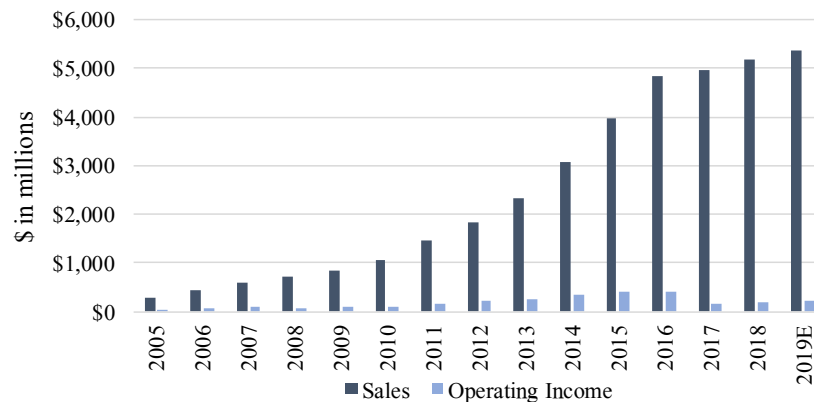
The U.S. pet insurance industry is a large and under-penetrated market, with premium volumes growing over 20% a year in total and Trupanion leading the way as the second largest insurer and quickly approaching the #1 provider, Nationwide Pet Insurance.

Trupanion has several advantages. It benefits from providing the highest value pet insurance coverage for premiums charged, i.e. low-cost provider. It also has a large network of territory partners throughout the country who built relationships over multiple years with animal hospitals. Lastly, its point of sale software, Trupanion Express, provides the ability to speed up claim payment and pay animal hospitals directly to veterinarians.

On the surface, Trupanion’s financials may look unusual in that they have no GAAP earnings. This is because insurance premiums are priced 30% above expected claims expense, called Trupanion’s “pricing promise”. The average loss ratio for a specialty property insurer is 56% vs. Trupanion’s 70% target, hence the best value proposition relative to competitors.

Trupanion has been cash flow positive since 2016. After paying 70% of premiums received towards claims, Trupanion has 30% of premiums to pay all other operating costs. Once all non-marketing operating costs are paid, Trupanion uses the remaining cash to reinvest in pet acquisitions costs to grow the business, resulting in essentially breakeven earnings but very strong growth. Once Trupanion reaches scale at 650,000-750,000 insured pets, it expects to have ~15% adjusted operating margins at which point it will be very difficult for any competitor to offer a similar value proposition.

Typically growth and earnings are at odds with each other. It often takes money to make money. As long as Trupanion is able to effectively reinvest capital at attractive incremental rates of return, it should invest as much available capital as possible. The lower the earnings today, the greater the growth in future cash flow, and therefore the higher intrinsic value becomes.

Under Armour, Inc. (UA):

Source: Factset Research Systems, Inc.

Sales and operating income grew a respective 4% and 14% in 2018 and are expected to grow a respective 3% and 30% in 2019. Operating income peaked in 2016 at \$417 million and is still recovering from the 2017 headwinds and subsequent restructuring plan.

Under Armour's key advantage is its brand. It can be difficult to distinguish between an enduring brand or a trendy fad. Brands are a promise built over many years and interactions between a company's product/service and its customers. With brands, there is customer captivity within the search costs of not knowing if a non-branded product will be of similar quality to something you are familiar with. What is the value to a consumer in drinking Coca Cola or using Crest toothpaste versus a private label alternative?

A brand in and of itself is not necessarily a competitive advantage. For example, Mercedes Benz is one of the most admired and respected auto brands in the world. Its brand has been a status symbol for quality and success; however, the brand has not translated into significant profitability for the company throughout the years. It is the barriers to entry that determines whether an advantage truly exists and therefore provides a company with above average economic returns.

U.S. luxury auto manufacturers did not always earn lackluster returns. Before foreign luxury cars entered the U.S. in the 1970s and 1980s, Cadillac and Lincoln had attractive returns on invested capital. These high returns attracted Mercedes and BMW to enter the market, later followed by Lexus, Acura, and others. While the prices on these luxury cars remained at a premium price point, total U.S. auto demand remained stable while the market became more fragmented among the many luxury auto manufacturers. Unit sales declined for Cadillac and Lincoln and were then shared among several other competitors. The companies still had to spend heavily on product

development, advertising, and its service networks but the fixed costs were spread across fewer sold cars, therefore increasing fixed cost and lowering net profits per car sold.

Alternatively, the larger sports apparel companies such as Nike, Adidas, Anta (Fila), Columbia Sportswear, and Under Armour until recently, have all consistently earned very attractive returns on capital. Each of these companies sells its products around the world and to a similar target market.

If the returns are so attractive, why don't new competitors enter the market, undercut on price, steal share, and inevitably push returns down to just average? The answer is barriers to entry, a large and growing end-market, and the primary competitors each trying to sell high quality, premium priced products.

It takes many years and interactions with athletes to build trust that a product is high quality and will perform as expected. Under Armour and Fila are the only major sports apparel companies to emerge as players on a global scale in recent decades. Under Armour was started in 1996 and had 2018 sales of \$5.2 billion. Fila is headquartered in South Korea, started in 1991 and had 2018 sales of \$3.6 billion. Lululemon is in a similar category but is more focused on serving the high-end female athleisure market. It was started in 1998 and had 2018 sales of \$2.6 billion. Outside of these companies, few have been able to go head-to-head with Nike and Adidas. It has proven very difficult to start and build a widely accepted/trusted sports brand.

While economies of scale will make it difficult for many new sporting apparel companies to pop up, it is true Nike and Adidas, being a respective 7x and 5x Under Armour's sales, have a relative advantage. Nike and Adidas' size gives them wider brand recognition, relationships and negotiating power with suppliers and distribution channels, and marketing and sponsorship deals with top athletes. Despite Nike and Adidas' favorable unit economics, Under Armour was able to prosper and become the fastest athletic apparel brand to reach \$500 million and then \$1 billion in sales, initially growing in its niche Football market and expanding from there.

Beyond the barriers for new entrants, the major existing players have another advantage, they are all focused on providing premium, high quality products. This helps all three earn attractive economics. Let's say there was a Nike, an Adidas, and an Under Armour jacket on sale for \$100 each. A competitive market would expect one company to discount its jacket to \$80 to take market

share, sell more jackets, and make more profits. Subsequently the other companies would lower their prices as well until the price reaches a point that profits become unattractive.

While this is what is to be expected in a competitive environment, if each of the three companies were determined to sell high quality products at premium price points *and* the market demand was large enough to support all three companies, each could earn attractive returns.

The above example and investment thesis for the premium sports apparel industry assumes all three major companies want to sell premium products and won't discount products to the point it makes them economically unattractive. This thesis was tested in 2016 when Sports Authority filed bankruptcy which impacted the entire U.S. sporting goods industry, particularly Under Armour which had 90% of sales in the U.S. at the time. Retailers were stuck with excess inventory and forced to discount and move apparel to off-price channels. Nike poured fuel on the fire when it reduced its minimum advertised price in late 2016 for the first time in its history, allowing retailers to advertise discounts by as much as 25% on its shoes and apparel during 2017.

Companies that go through some type of adversity and survive, often come out stronger on the other end. Since 2016, excess industry inventories have declined, Nike's minimum advertised price returned to normal, and Under Armour has refocused on operational efficiencies through better segmented product, inventory management, and SKU rationalization.

While we expect each of the major sports apparel companies to fare well financially over the long-term, we think Under Armour shares look attractively priced to outperform going forward. Under Armour has the ability to compete with the big players and grow from a much smaller base as they continue to achieve greater economies of scale. Once its cost structure is optimized and margins return to historic levels, we expect earnings power to reaccelerate.

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. So far, we could not be happier in this regard. We would love to continue to grow with like-minded investors. If you know someone that may potentially be interested in an alternative investment strategy like the Saga Portfolio, feel free to forward on our information. 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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