LUCA
CAPITAL ADVISORS

DURABLE GROWTH PORTFOLIO

2021 Annual Letter

Our Investors:

Our net return since inception Oct 1, 2019, has been 88.2%, for an annualized net return of 32.4%.

We believed 2021 was going to be a challenging year after the incredible year we had in 2020, given that valuations in growth stocks were at historic highs. However, we didn't know if they'd continue to rise, be flat, or decline in 2021. At the beginning of 2021, it looked like they were going to continue to rise, but they corrected in March and then there was a steep selloff in November and December. After the selloff we finished 2021 with a -18% return.

Despite the recent volatility, our portfolio companies continue to grow revenues faster than most companies of the past, generate substantial free cash flow or have a clear path to do so, are run by exceptional CEOs, and provide essential value for their customers. While multiples will expand and contract, growth of intrinsic value is what drives stock prices over the long-term and our companies are increasing in intrinsic value at high rates each year.

As long-term investors, **we are focused on the 2020s and not just 2021**. This is not the first time we've experienced a sharp pullback and it won't be the last. While this is an uncomfortable part of public stock market investing, we remain focused on the things we can control, such as repositioning the portfolio to take advantage of the best available opportunities today. Sharp selloffs create dislocations of value and this is fertile ground for long-term opportunities.

It is important to remember that stocks are more than quotations on a screen. They are fractional ownership of businesses. The key to investment success is to roughly figure out what a company will be worth 5 years, 7 years, 10 years from now and pay a lot less than that today.

My long-term confidence in the Durable Growth Portfolio has not changed. In January 2022 I increased my personal investment in the Durable Growth Portfolio by over 60%.

Michael T. Nowacki
Lead Portfolio Manager

Three Types of Market Declines

Since we finished the year with a sharp pullback, it is fitting to start the letter reminding investors of the three types of market declines. These vary in frequency and severity.

Systemic declines are the most severe of all pullbacks. They occur when there is a loss of confidence in a country's financial system and a severe decline in GDP. This usually results in a credit crisis and lack of liquidity. The bank runs of the early 1930s, the Financial Crisis of 2007-2009, and the 2020 Covid-19 Crisis represent these types of events.

Cyclical declines are often referred to as bear markets. These downturns can last years and typically involve recessions. Since the Panic of 1785 the U.S has had a recession at least once or twice a decade. The 2020 Covid-19 Recession was 10 years and 8 months since the 2007-2009 Recession, the longest period between recessions in U.S. history.

There were 34 business cycles in the United States between 1854 and 2020. The average length of a growing economy has been 41 months. The average recession lasts for 17 months.

Since 1945 the business cycle has improved: 8 cycles with an average expansion of 65 months and an average recession length of 10 months. Cyclical declines are part of the economic cycle and the troughs are often the best times to find new investment opportunities.

***Technical declines*,** or industry re-ratings, are when there is a dislocation between fundamentals and valuations, usually because a part of the market has appreciated substantially in recent times. The subsequent pullbacks are often referred to as "corrections" by the investment community. When equity valuations get out of line with fundamentals, prices correct accordingly. Technical pullbacks can be sharp but are generally short-lived with the bottoming occurring over a period of weeks or months. What we have experienced in growth stocks the last two months of 2021 was a technical decline.

When To Sell

Knowing when to buy is usually easier than knowing when to sell. Stocks are bought because there is a high probability of earning superior returns. Stock prices change though, so investors must constantly re-evaluate the future return prospects. Selling just because a stock has gone up a lot is not a strong strategy; great companies go up and continue to go up over time. Selling just because the stock has gone down a lot is also not a strong strategy; great companies have pullbacks too and that could be an opportunity to add shares.

Stocks move daily and they don't go up every month, quarter, or year. Even the greatest companies reach 52-week highs, fall, then reach new highs in the future. Trying to trade in and out of great companies based on valuation is likely to increase taxes and reduce performance. It is also likely to lead to seller's remorse as good companies can trade at high levels for a long time. When veteran investors are asked about the biggest mistakes in their careers, the response is usually that they sold an incredible company just because it looked too expensive at the time.

We have three reasons we sell a stock

(1) The company has failed to live up to expectations. Investing is based on probabilities and there is never a 100% probability a company will meet our expected returns. If there is an 80% probability, that means 1 out of 5 companies won't live up to our expectations.

(2) The nature of the business has changed. The CEO left, they made a big acquisition that doesn't make sense, competition is gaining on them, the industry is struggling to grow, or the company is now mature/saturated its market and slow growing.

(3) We find an investment that clearly has better prospects

The Three Best Ways to Think About Public Market Investing are Long-Term, Long-Term, and Long-Term

We are experiencing the most innovative period in U.S. history since the Industrial Revolution. The Durable Growth Portfolio was created to capitalize on investment opportunities in these innovative areas, such as digital advertising, software, e-commerce, digital payments, cybersecurity, and health technology.

The long-term trend of investing into these industries began or accelerated in the 1990s with the widespread adoption of the personal computer and the Internet. While the dotcom boom and bust of the late 1990s – early 2000s is scarred into the memories of investors, there were many great companies that were created or emerged during this period and went on to dominate their industry for the next two decades, such as Microsoft, Amazon, Nvidia, PayPal, Oracle, Adobe, Cisco, and Qualcomm. In the Durable Growth Portfolio, we are trying to find the dominant companies of the future.

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Trying to predict short-term winners is a difficult game and one we do not want to play. Some people believe that if you cannot get the next quarter right, you cannot possibly get the long-term right. But that's like saying if you cannot predict how Tom Brady will perform in next week's game, you cannot possibly predict how he'll do on the season. Yet he does well every season. In public market investing, our seasons are longer. Investment results should be judged over at least 5 year period.

We cannot promise consistency of returns. In fact, we can promise returns won't be smooth. The broad stock market does not provide smooth returns—the returns vary significantly from year to year.

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Intelligent investing is properly measuring the downside before calculating the upside. And skillful risk management is knowing how much you can permanently lose on an investment and the probability of that happening.

It’s also important to distinguish between temporary short-term losses on paper and permanent losses. All great companies have pullbacks of -50% or more at some point, but so do terrible companies. Patience is important when a stock isn’t performing, but as investors we also must ask ourselves, are we being patient or are we are being stubborn?

Valuation multiples are feedback about what investors collectively think about the company. Stocks trade at low multiples because investors collectively think it doesn’t deserve a high multiple, either because it has slow growth, growth that isn’t durable, or the quality of the company is poor. And stocks trade at high multiples because investors collectively think it deserves a high multiple based on growth and qualitative factors. However, investors can quickly change their mind about what multiples a company deserves, which is why independent thinking is so important.

The market will tell you what it thinks the current valuation multiples should be and one can easily look up the fundamentals of a company. What makes investing so difficult, though, is that you are making predictions about both the future fundamentals of a company and the future valuation multiples of that company. One way to predict future valuation multiples is to look at where the more mature companies in the industry typically trade. For example, if Palo Alto Networks typically trades at a P/S of 8x with 20% revenue growth, a reasonable assumption would be that if Crowdstrike were to have similar margins, it should trade at 8x Sales when it reaches 20% revenue growth.

Quarter to quarter there is almost no correlation between a company’s fundamentals and its stock price—a company reports on four days of the year, but the stock moves 252 days a year. In the long-run though, there is a high correlation between the fundamentals and stock price. Another way of saying this is that in the short-term, stock price movements are merely changes in valuation multiples, but in the long-run fundamentals primarily drive stock returns.

For young companies, revenue is the part of the fundamentals that we are specifically referring to that drives intrinsic value and stock prices in the long-run. Revenue is a leading indicator of earnings and cash flow. That is why we see the benefit in owning companies with revenue growth that is not just high today, but also with slow deceleration of growth so that revenue can still be growing 20% in 10 years. Hence the name *Durable Growth Portfolio.*

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