



Durable Growth Portfolio

1H 2021

To Our Investors:

The purpose of our investor letters is to communicate our recent performance and educate investors on our investment approach. As always, we are available to discuss these things in greater detail with you one on one.

H1'21 Results

During the first half of 2021, the Durable Growth Portfolio increased 5.1% net of fees. This compares to the overall increase, including dividends, for QQQ and SPY of 13.2% and 15.2%, respectively. Since inception on October 1, 2019, the Durable Growth Portfolio returned 141.2% net of fees, compared to QQQ and the SPY of 44.2% and 25.4%, respectively.

Durable Growth Monthly Performance (net of fees)

Year	Jan.	Feb.	Mar.	Apr.	May.	Jun.	July.	Aug	Sept	Oct.	Nov	Dec	Durable Growth	QQQ	SPY
2019										2.58%	4.97%	1.23%	9.0%	12.9%	9.0%
2020	6.57%	-6.37%	-15.21%	25.39%	19.99%	10.56%	15.45%	7.80%	2.58%	-4.83%	12.75%	9.19%	110.5%	48.6%	18.4%
2021	8.63%	-1.30%	-8.69%	2.81%	-3.25%	7.97%							5.1%	13.2%	15.2%
Cumulative return since inception													141.2%	89.9%	48.7%
Annualized return since inception													65.4%	44.2%	25.4%

What Is Investing?

What is investing? A common definition is that investing is the act of expending money today, with the expectation of future profit. However, *expecting* future profit is not the same thing as being *guaranteed* future profit. When it comes to investing into businesses, there are no guarantees of specific returns—there is a range of possible future returns and different probabilities each return will be achieved.

In other words, investing is dealing with uncertainties and probabilities. It requires forecasting future fundamentals of a company, future sentiment about that company and industry, and future valuation multiples.

Many investors focus so intensely on the small things, such as if margins expand or contract 1% this year, whether the forecast for next quarter is soft or strong, if the company has an increase in job openings, if satellite images of parking lots show workers staying later, etc. These investors believe this attention to small details gives them an edge. We take the opposite approach and believe that big picture thinking is our edge—if we get our predictions and forecasts about the big things right, the small things tend to take care of themselves over time. We call this “visibility” and the higher the visibility about the future company fundamentals and competitive dynamics, the more comfortable we become with our investments.

As someone once said, “Making predictions is tough, especially about the future.” Forecasters (investors) must be humble because we never know the true probabilities. You might think there

is a 90% chance a company returns 20% to 25% over the next five years and someone else might think there is only a 50% chance. Who is right?

The performance of the stock does not tell us who was right in their probabilities, it only tells us the outcome. If I say there is a 90% chance that I am going to get heads when I flip a coin and then I get heads, that doesn't mean my probabilities were correct, there was still only a 50% chance I got heads. And if I say there is a 90% chance something is going to happen and it doesn't, that doesn't mean I was wrong, I will "appear" wrong 1 out of 10 times if my probabilities were correct.

Investors talk a lot about having "high conviction". A friend of Luca likes to say, having high conviction doesn't mean you are right, it only means you think you are right! Having high conviction and being wrong is a proven way to lose confidence in yourself and have others lose confidence in you.

What investors mean by high conviction is that they have high confidence the stock has limited downside and there is a low probability of that happening, and there is an extremely high probability it will provide high returns. High conviction is not the same thing as certainty. Anyone who says they are certain about things that are uncertain, should not be trusted with money.

Robert Ruben, the former co-head of Goldman Sachs and Secretary of the Treasury had this to say in his memoir *In An Uncertain World: Tough Choices from Wall Street to Washington*, co-authored with Jacob Weisberg:

"And once you enter the realm of probabilities, nothing is ever simple again. A truly probabilistic view of life leads quickly to the recognition that almost all significant issues are enormously complex and demand that one delve into those complexities to identify the relevant considerations and the inevitable trade-offs. Some people I've encountered in various phases of my career seem more certain about everything than I am about anything. That kind of certainty isn't just a personality trait I lack. It's an attitude that seems to me to misunderstand the very nature of reality—it's complexity and ambiguity—and thereby to provide a rather poor basis for working through decisions in a way that is likely to lead to the best results."

If investing is dealing with uncertainty and probabilities, then how do we become better at investing?

- (1) **First, think in terms of probability and scenario analysis. Reject the idea of certainty.**
- (2) **Only forecasting companies for which you believe you can forecast reasonably well.** You should understand the business well and the industry. Warren Buffett calls this sticking to your circle of competence and companies outside of this area belong in the "too hard pile". If you are failing to be comfortable with your forecasts, move on. You only have to be right about the companies you buy.

Everyone starts with an empty circle of competence as a teenager. Investors can leave it to fate to guide them to develop competence in the areas with the best opportunities, or one can make a conscious effort to become more competent in those areas over time. Our approach has been to increasingly build our circle around software, payments, digital advertising, cybersecurity, e-commerce, and health tech.

- (3) **Experience and pattern recognition.** If you are inexperienced and new to investing, you are unlikely to be skilled at assessing probabilities. Measuring your past investments and learning from them is important, but so is studying history, a wide variety of businesses, and other investors.
- (4) **Seek opposing opinions.** Know your biases and correct for them. Whether they are short-seller reports, analysts, other investors, or team members, we find value in seeking different viewpoints. It helps with risk management, which to us means managing the amount we can permanently lose on any investment.
- (5) **Continuously review and revise your forecasts.** Don't react emotionally when there are substantial price moments or fundamentals miss guidance. Re-evaluate with a cool demeanor.

No matter how talented one is at assessing probable outcomes, there should also be protection of the downside. Our first question is "How much can we lose on this investment?" Our second question is "How much can we make?" Risk management always comes first.

Wide diversification narrows the range of future outcomes of a portfolio, both the downside and upside. We believe there is a way to limit the downside without limiting our upside, and that is through managing risk at the individual stock level and carefully choosing the handful of stocks that will make it into our portfolio.

Investors often talk about asymmetric bets, and we look for them as well. However, there is a caveat. Consider a coin flip where you lose 50% of your money if you are wrong and 10x your money if you are right. That is an asymmetric bet, but we would pass on it unless we can find dozens of bets with those same odds and payouts. If we can only find one investment with those payouts and invested heavily, there is a 50% chance of us permanently losing 50% of our money and that is a risk we don't want to take.

Our investment targets are companies with small downside and large upside. When we find a rare opportunity that is extremely low risk and extremely high reward, we want the size of our position to match our conviction.

Outperformance is Sporadic, Not Constant

“Often, there is no correlation between success of a company’s operations and the success of its stock over a few months or even years. In the long term, there is 100% correlation between the success of the company and the success of the stock. This disparity is the key to making money; it pays to be patient, and to own successful companies.

–Peter Lynch, *Beating the Street*

Investing is a strange world, where everyone places a high value on your performance in the one or two negative years in a decade and values your total return over that decade much less.

Common questions from asset allocators are “Have you been tested in a bear market? How did you do?” What allocators should be looking at is how investors performed in the bear market years and the following years. Did the investors take advantage of the dislocations of value? If so, those investors are one’s allocators should consider *adding to* in a bear market!

Outperformance is sporadic, not constant. In the public markets, volatility is the price you pay for outperformance. Consider a few of the great companies of the past decade. Alphabet (Google) has returned approximately 22.5% annually from 2009 – 2020. It underperformed the S&P 500 in 5 of those years. Amazon returned roughly 41% annually over that same period and it underperformed in 4 of those years. Netflix returned roughly 50% annually over the same 12 years and underperformed in 4 of those years. Salesforce returned roughly 32% annually to investors over the 12-year period and underperformed in 5 of those years.

In other words, owning a concentrated portfolio of some of the best companies on the planet, can still lead to underperforming the S&P 500 in 4 to 5 out of 12 years.

We have no idea how the stock market will perform over the short-term, but we are happy with the performance of our companies—if they were all privately held, we’d be ecstatic every time we opened the quarterly statements.

We have been fortunate to attract a strong, aligned investor base and are honored that you have chosen to invest your hard-earned capital with us.

Sincerely,

Luca Capital Advisors

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