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What Every Portfolio Needs: Underperformers

"It ain't what you don't know that gets you into trouble.
It's what you know for sure that just ain't so."
Mark Twain

Markets climbed the proverbial wall of worry in the third quarter. Risks, such as weak seasonals and China, transpired better than expected, powering the market higher. The best performers differed from earlier this year, with the Mag 7 and tech lagging while small and mid-caps outperformed. Patient Opportunity Trust (Class I) gained 5.93% in the quarter, in line with the S&P 500's 5.89% increase.

In markets and investing, it's easy to get sucked into the vortex of short-termism. We could fill pages with the quarter's market moving jobs, inflation and Fed headlines. Investors must assess a constant stream of news. Only with hindsight can we see that most is noise.

We remain in a bull market. Since the low in 2022, the S&P 500 has advanced 61%, the fourth best 2-year plus cyclical bull market in the post-War period[1].

Markets are up strongly for the year. The S&P 500's 22.1% gain is its 16th best start to the year since 1927. The Nasdaq

Average Annual Total Returns and Expenses (%) as of 9/30/24

	Without Sales Charges						With Maximum Sales Charges						
	QTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception*	QTD	1Yr	3 Yr	5 Yr	10Yr	Inception*	Inception Date
Class A (LGOAX)	5.84	37.50	-1.27	10.55	8.55	14.51	-2.77	29.60	-3.20	9.25	7.91	14.08	2/3/09
Class C (LMOPX)	5.62	36.48	-2.04	9.70	7.73	6.42	4.62	35.48	-2.04	9.70	7.73	6.42	12/30/99
Class FI (LMOFX)	5.82	37.47	-1.34	10.47	8.49	6.52	5.82	37.47	-1.34	10.47	8.49	6.52	2/13/04
Class I (LMNOX)	5.93	37.90	-1.01	10.83	8.84	7.47	5.93	37.90	-1.01	10.83	8.84	7.47	6/26/00
Class IS (MVISX)	5.94	37.97	-0.95	10.91	-	5.52	5.94	37.97	-0.95	10.91	-	5.52	8/22/18
Class R (LMORX)	5.79	37.11	-1.53	10.26	8.24	5.43	5.79	37.11	-1.53	10.26	8.24	5.43	12/28/06
S&P 500	5.89	36.35	11.91	15.98	13.38	7.69	5.89	36.35	11.91	15.98	13.38	7.69	
Russell 2000	9.27	26.74	1.81	9.35	8.76	7.67	9.27	26.74	1.81	9.35	8.76	7.67	

*S&P 500 since inception return represented from 12/30/99, the Fund's oldest share class.
Gross (Net) Expenses (%): Class A 2.12 (2.11); Class C 2.88 (2.87); Class FI 2.17 (2.16); Class I 1.88 (1.85); Class IS 1.78 (1.77); Class R 2.38 (2.37).

***Performance shown represents past performance and is no guarantee of future results.** Current performance may be higher or lower than the performance shown. Patient Capital Management has agreed to waive fees and/or reimburse operating expenses through April 30, 2025, so that such annual operating expenses will not exceed 0.88%, subject to recapture as described below. With respect to Class I only, the Adviser has agreed to waive fees and/or reimburse operating expenses such that the previously described annual operating expenses, plus intermediary servicing fees and other class-specific expenses, will not exceed 0.93%. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than the original cost. Class A shares have a maximum front-end sales charge of 5.75%. Class C shares have a one-year contingent deferred sales charge (CDSC) of 1.0%. If sales charges were included, performance shown would be lower. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived in various periods. YTD is calculated from January 1 of the reporting year. All classes of shares may not be available to all investors or through all distribution channels. For the most recent month-end information, please call 800-655-0324 or visit patientcapitalmanagement.com/opportunity-trust.*

advanced 21.8%, while the Dow returned 13.9%. Small and mid-caps have lagged but still posted respectable returns with the S&P 600 up 9.3% and the Russell 2000 up 11.2%. Internationally, same story. The MSCI World Index notched a 19.3% increase.

Fortunately, plentiful caution accompanies the strong run. Money market funds recently hit an all-time high of $6.5T. According to UBS[2], defensive stocks outperformed cyclicals in the quarter. Inflation is back below 50-year averages and economic growth remains solid. Recession fears have plagued the market's entire advance.

Our returns have been strong, though we'd prefer stronger. The Fund's 16.76% (Class I) year-to-date return bested the Dow and smaller cap indices, but lagged our primary benchmark the S&P 500. Most investors are satisfied with high-teens annual returns, but we aim to outperform our benchmark.

Several factors weighed on our relative performance. The best year-to-date performers have been large cap, quality names with high momentum. As value managers focused on exploiting opportunities where market expectations diverge most from underlying intrinsic values, we tend to sell into strength and buy into weakness. Our all-cap and cyclical exposure also impacted us. Given the relative opportunity set, we have conviction our approach will benefit us long term.

Fortunately, our longer-term numbers remain strong. Since taking over sole management of Opportunity Equity[3] at the end of 2022, the Fund (Class I) up 62.99% (32.13% annualized) vs. the S&P 500's +54.14% (27.99% annualized).

We believe our investment process works and is differentiated. At Patient Capital, we are compounding evangelists. We want to maximize our investors' wealth. Only dollars in the bank pay bills and improve living standards.

The US equity market, as measured by the S&P 500, has grown at an annual rate of 9.71% since the end of 1927. One thousand dollars invested at the beginning of the nearly 97-year period would be worth $7,881,300 today.

To reap those rewards, an investor had to do *nothing*. Just buy and patiently hold. Unfortunately, doing nothing can be exceedingly difficult.

During that period, we faced the Great Depression, a World War and other military conflicts, more than a dozen recessions, a Financial Crisis, pandemics, terrorist attacks, oil shocks, government dysfunction and other traumatic events, a point Warren Buffett likes to make. Each caused significant losses and triggered fear. Investors were frequently tempted to disrupt compounding's magic by selling into weakness, and many did so.

There are other compounding-killers. Investors tend to chase what's hot, and fund by selling what's not, and myopically focus on avoiding losses.

At the height of the Tech Bubble in 2000, investors believed technology had fundamentally changed the economy and promised a whole new world. Retail and institutional investors piled in. At the climax of the housing bubble, people believed housing was immune to price declines representing unbeatable risk-adjusted returns.

Individual investors suffer a bad rap for poor timing, but professional investors face similar temptations due to short-term performance pressures. Bloomberg recently ran a story on Harvard endowment's performance challenges[4], attributing them to "a classic investment mistake: shifting strategies at inopportune times, chasing gains and, in short, buying high and selling low".

The story notes treasurer Ron Daniel presided over "astonishing growth of the school's endowment". Over the past 20 years, since he left, things turned south. Harvard's 8.8% annualized return ranked seventh of the eight Ivy League universities.

After poor performance in the financial crisis, Harvard "reduced risk". It also added to natural resources, which did great in the 2000s and terrible in the 2010s. In hindsight, obvious errors. Yet, most investors would have followed a similar approach. When faced with underperformance, investors analyze sources of drag, then change those things.

A logical approach, except it mostly backfires for two reasons. 1) All our information is about the past, while returns are determined by the future. 2) The market is a discounting mechanism. Prices adjust along with our hopes, fears and knowledge.

The longer something has underperformed, the lower its embedded expectations and the bogey for future gains. And visa-versa. Market expectations are a key determinant in the future return equation.

The Financial Crisis destroyed portfolios and scarred investors. People feared a lost decade and more losses. PIMCO[5], including Mohamed El-Erian who was coincidentally one of Harvard's former CIOs, coined the term "a new normal" to describe a muted growth and return outlook. It advocated more active risk management.

At the lows, the market reflected abundant fear and grim expectations. This set the stage for one of stocks' strongest decades. From the lows in March 2009, the S&P 500 gained 17.4% per year, a whopping 79% greater than the long-term average.

Many agreed with PIMCO's counsel. Hedge funds got defensive[6], and significantly underperformed. Since the end of 2014, hedge funds gained 5.0% on average per year versus the S&P 500's 13.0% per year. One thousand dollars invested in hedge funds over the period would be worth $1,606, half as much as what one earned in the S&P 500, $3,270.

To maximize wealth, one must tolerate the markets' inevitable ups-and-downs. As the great economist John Maynard Keynes noted[7], "It is the duty of the long-term investor to endure great losses with equanimity."

Easier said than done. Julian Robertson[8], the original Tiger fund, earned returns of nearly 32% per year from 1980 through 1998. That stellar track record didn't stop clients from withdrawing most of their money when he underperformed in the late 90s. Robertson accurately predicted the Tech Bubble. His decision not to participate doomed his firm. Tiger closed in March 2000 at the peak of the Bubble.

Robertson's final letter noted: "The tragedy is, however, that the only way to generate short-term performance in the current environment is to buy these (tech) stocks. That makes the process self-perpetuating until the pyramid eventually collapses under its own excess." He was exactly right. He still went out of business.

Given the tech crash that came next, investors would have been well served by adding to their underperforming Tiger positions rather than redeeming. That's often the case. Robertson's letter observed, "The key to Tiger's success over the years has been a steady commitment to buying the best stocks and shorting the worst."

Which brings us full circle, as that's exactly the approach that's worked best year-to-date. According to Bloomberg[9], momentum, size (larger cap), low volatility and quality are the best performing factors, while highest short interest and value are amongst the worst. Goldman Sachs[10] recently noted an unusually wide spread between valuations for high and low quality factors.

While we love compounding, the pervasive enthusiasm for "quality compounders" makes us nervous. It's empirically well-founded. Arizona State's Hendrik Bessembinder's research[11] shows that less than 1% of companies generated half the wealth creation of US stockholders since 1926. Charlie Munger convinced Warren Buffett (and the rest of us) that "a great business at a fair price is superior to a fair business at a great price."

Top Ten by Issuer as of 9/30/24

Name	**% of Portfolio**
QXO, Inc.	6.4
Amazon.com, Inc.	6.3
Alphabet Inc.	5.3
Citigroup Inc.	5.0
Expedia Group, Inc.	5.0
IAC Inc.	4.7
Energy Transfer LP	4.5
Meta Platforms, Inc.	4.4
Nvidia Corp.	4.1
Alibaba Group Holding Ltd.	3.7
Total	**49.4%**

Unfortunately, Mae West's claim that "too much of a good thing can be wonderful" is rarely the case in markets. As sentiment and valuation ratchet up, future returns tend to rachet down.

In Stocks for the Long Run, Jeremy Siegel[12] compares the fundamentals and stock returns of IBM to Standard Oil of NJ from 1950-2010. IBM developed the first commercial computer and dominated technology while oil's importance to the economy declined significantly. Oil stocks fell from 20% of the market to nearly half that.

IBM grew revenue per share and earnings per share 11% per year while Standard Oil grew those same measures 8% per year. Yet, Standard Oil's stock returned 14.5% while IBM's returned 13.0%. Why? Valuation matters. IBM's beginning P/E was 22.5x with a 2.2% dividend yield. Standard Oil traded for 12.9x with a dividend yield of 4.2%

Rising quality compounder valuations reflect widespread recognition of their merits. Below is a sample of some widely recognized compounders' historical valuations. Their average forward P/E is ~35.5x, a 47% premium to the S&P 500's 24.2x. In 2010, you only needed to pay a 3% premium for this basket, great starting conditions.

The compounders' average multiple has grown 25% since pre-pandemic and 86% from 2010 to 2019 (vs. 20% and 63% respectively for the S&P 500). The S&P 600 Small Cap index, on the other hand, saw declining valuation multiples (by around 15%)!

Compounders: 2010, Pre-Pandemic Valuations and Now

Company	Ticker	12/31/2010	12/31/2019	Current	2010 - 2019	2019 - Current
					% Change	
Apple	AAPL	16.7x	22.4x	34.8x	34%	55%
Coca-Cola	KO	18.8x	26.3x	25.2x	40%	-4%
Costco	COST	18.0x	32.2x	49.7x	79%	54%
Danaher	DHR	13.8x	29.2x	36.6x	112%	25%
Microsoft	MSFT	11.3x	29.2x	32.6x	158%	12%
Moody's	MCO	13.8x	29.0x	41.7x	111%	44%
Visa	V	14.7x	30.2x	27.7x	106%	-8%
Average		***15.3x***	***28.4x***	***35.5x***	***86%***	***25%***
Median		***14.7x***	***29.2x***	***34.8x***	***99%***	***19%***
S&P 500		***14.9x***	***20.2x***	***24.2x***	***63%***	***20%***
S&P 600 Small Cap		***23.1x***	***22.5x***	***19.4x***	***-16%***	***-14%***

Source: Bloomberg Best P/E Forward Estimates of Current Year

We see similarities to the Nifty Fifty[13] period of the late-60s and early-70s, when people touted "one-decision growth stocks" that you could buy and hold forever.

Investor sentiment, market performance and valuations rhyme. In December 1972, the Nifty Fifty peaked at 41.9x trailing earnings, a slight premium to the 36.3x trailing multiple for our compounder group. The Nifty Fifty returned 43% on average in the trailing twelve months before the peak vs. 38.1% for our compounder group. Over the prior five years, the Nifty Fifty's 28% annual returns exceeded our compounder's 21% returns.

While we aren't quite yet at the extreme reached in 1972, it's close enough to warrant caution. The Nifty Fifty lost half their value over the two years after the peak. This occurred despite not being significantly overvalued as Jeremy Siegel's excellent analysis[14] demonstrated. The Nifty Fifty went on to earn roughly market returns over the next 25+ years.

Investor crowding, along with a bear market were enough to trigger significant losses. The 1973-74 bear market included an oil shock, severe inflation and a nasty recession. Fortunately, similar conditions don't appear imminent.

We prefer it when behavioral conditions favor our investments. Pessimism and fear are an investor's friend. We agree on the merits of compounders, but believe the current environment calls for discretion and discrimination, in our view.

Our investment process entails careful analysis of intrinsic business fundamentals and market expectations. We want rock-bottom expectations, and superb and improving fundamentals. It's never that easy. We spend vast hours trying to find the rare times the market gets it wrong.

As assets have flowed to compounders and tech away from value, international and small cap, we see greater opportunity in the latter. We encourage investors to embrace their underperformers!

In the quarter, we added two new holdings, QXO (QXO $15.77) and Dave & Busters (PLAY $34.05), both small-to-mid caps. We exited JP Morgan, Everi and some TCRT expired warrants (a company previously known as Ziopharm). JP Morgan is a fabulous company that we've owned since the financial crisis. At current levels, we think it's fully valued and unlikely to outperform. Apollo announced a takeout of Everi.

QXO ended the quarter as our largest position, an unusual circumstance for a new holding. We purchased QXO in a PIPE[15] transaction during the quarter. The stock is off to a good start ending the quarter at $15.77, 73% above the $9.14 deal price, which took the position size to our top slot.

We follow proven money-makers, and paid attention when Brad Jacobs took over QXO. Jacobs had a successful track record driving results at numerous companies including United Rentals, United Waste, XPO Logistics, GXO and RXO. He's best known for XPO, which went from $3 prior to his takeover in 2011 to the current $108, 36x as high, a compound rate above 30% per year!

His strategy at all his companies was to use technology to improve the customer value proposition. He plans to do the same again, this time in the building products space. Jacobs' objective is to grow partner capital at 25% per year, or 10x over the next decade. Jacobs wanted long-term oriented partners. We never anticipated being "Patient Capital" could help with deal access, but it did. We are very early but see significant long-term compounding potential in QXO.

Dave & Busters is an entertainment attraction, offering games and food. It's recently been pressured by low-end consumer weakness. It bought its prime competitor Main Event in 2022 with Main Event's CEO, Chris Morris, assuming leadership. Morris's strategic plan includes improvements in pricing, remodeling, cost savings, events and more. It estimates changes will improve EBITDA by $680-915M, a significant amount relative to the current 2024 estimated base of $528M. Early results are promising.

Dave & Busters has solid unit economics and attractive returns on capital. The company has been aggressively buying back stock, shrinking shares outstanding by 19% since the beginning of 2023. We see solid growth prospects and strong cash generation as the company exits its current investment cycle. We think Dave & Busters can earn $8-9 per share in free cash flow in 3 years. At a 10x multiple, we believe the stock would be worth mid-$80s, which implies a compound rate of ~35% per year.

We have conviction in our portfolio. We have a well-diversified mix of attractively valued compounders, classic value and early-stage businesses. The portfolio trades at a significant discount to the market (12x forward earnings vs. 22x) with better earnings growth (26% 1-year growth vs. 14%), an attractive mix. We will continue to carefully assess company fundamentals along with market expectations to position the portfolio for maximal compounding.

Samantha McLemore, CFA
October 8, 2024

*Stock prices as of market close on September 30, 2024

[1]Ned Davis Research

[2]https://www.investing.com/news/stock-market-news/stay-overweight-defensives-ubs-strategists-say-3616764

[3]The Strategy was co-managed by William H Miller III and Samantha McLemore from 1/1/2014 to 12/31/2022. Samantha McLemore became the sole portfolio manager of the Strategy effective 1/1/2023.

[4]https://www.bloomberg.com/news/features/2024-09-29/harvard-endowment-generates-poor-returns-rich-pay-over-20-years

[5]https://www.forbes.com/forbes/2010/0208/investing-mutual-funds-stocks-pimco-new-normal.html

[6]https://www.aurum.com/hedge-fund-data/industry-performance/hedge-fund-performance-by-strategy-latest-data/

[7]https://www.investopaper.com/news/john-maynard-keynes-thoughts-on-investing-speculation/#:~:text=%E2%80%9CIt%20is%20the%20duty%20of,endure%20great%20losses%20with%20equanimity.%E2%80%9D

[8]https://en.wikipedia.org/wiki/Julian_Robertson; https://charlessizemore.com/keeping-perspective-julian-robertsons-last-letter-to-investors/

[9]https://en.wikipedia.org/wiki/Stocks_for_the_Long_Run

[10]https://publishing.gs.com/content/markets/en/2024/09/28/deb4437f-c9dc-4733-b8c7-c8cde759bcf1.html

[11]https://media.bailliegifford.com/mws/affgqguh/20240531102652_lessons-from-bessembinder-pdf.pdf

[12]https://csinvesting.org/wp-content/uploads/2015/11/valuing-growth-stocks-revisiting-the-nifty-fifty.pdf

[13]https://bridgeway.com/perspectives/party-like-its-1972-what-can-the-nifty-fifty-teach-us-about-todays-market/

[14]http://csinvesting.org/wp-content/uploads/2015/03/valuing-growth-stocks-revisiting-the-nifty-fifty.pdf

[15]Private Investment in Public Equity

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PATIENT CAPITAL MANAGEMENT

Patient Capital Management LLC is an SEC registered investment advisor founded in 2020 by Samantha McLemore, majority owner and Chief Investment Officer. Formerly operating with Miller Value Partners, Patient Capital acquired the Opportunity Equity business in a transaction completing Bill Miller's succession plan. As of 9/30/24, Patient Capital operates independently managing $1.9B in assets featuring opportunistic, long-term, value-oriented equity strategies. The Firm is supported by a team of 9 professionals. Bill Miller remains a minority owner and adviser.

Data Sources: Bloomberg, Patient Capital Management

The **S&P 500 Index** is a market capitalization-weighted index of 500 widely held common stocks. Investors cannot invest directly in an index and unmanaged index returns do not reflect any fees, expenses or sales charges. The **NASDAQ Composite Index** is a market capitalization-weighted index that is designed to represent the performance of NASDAQ securities and it includes over 3,000 stocks. The **Dow Jones Industrial Average (DJIA)** is an unmanaged index composed of 30 blue-chip stocks, each with annual sales exceeding $7 billion. The DJIA is price-weighted, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes, such as the S&P 500. The **S&P SmallCap 600** Index seeks to measure the small-cap segment of the U.S. equity market. The **Russell 2000 Index** is a small-cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index. The **MSCI World Index** captures large and mid-cap representation across 23 Developed Markets countries. With 1,410 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **Nifty Fifty** was a group of 50 large-cap stocks on the New York Stock Exchange that were most favored by institutional investors in the 1960s and 1970s. **Magnificent 7** is a group of stocks made up of mega-cap stocks Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA). **EBITDA** is earnings before interest, taxes, depreciation and amortization and is a calculation of a company's financial health. **Dividend yield** is the ratio of a company's annual dividend compared to its share price. **Earnings per share (EPS**) is the portion of a company's profit allocated to each outstanding share of common stock and serves as an indicator of a company's profitability. **Price to earnings** is the market price per share divided by earnings per share. **Revenue per share** measures the amount of revenue generated for each common share outstanding. **Free cash flow (FCF)** is operating cash flow minus capital expenditures divided by the number of shares outstanding.

Morningstar Percentile Rankings represent a fund's total return percentile rank relative to its Morningstar category. The highest percentile rank is 1 and the lowest is 100. It is based on Morningstar total return, which includes both income and capital gains or losses and is not adjusted for sales charges or redemption fees. Morningstar ranked LMNOX in the top 5%, 55% and 63% out of 425, 364, and 251 Mid-Cap Blend funds for the one-, five- and ten-year periods ending 9/30/24, respectively. ©2024 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. Real estate investment trusts (REITs) are closely linked to the performance of the real estate markets. REITs are subject to illiquidity, credit and interest rate risks, and risks associated with small and mid-cap investments. The Fund may focus its investments in certain regions or industries, increasing its vulnerability to market volatility. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect, which may have a negative impact on the Fund's performance. Short selling is a speculative strategy. Unlike the possible loss on a security that is purchased, there is no limit on the amount of loss on an appreciating security that is sold short.

Fund holdings and sector allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security.

Earnings growth is not a measure of future performance.

Diversification cannot assure a profit or protect against loss in a down market.

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