LUCA CAPITAL ADVISORS

DURABLE GROWTH PORTFOLIO

2020 INVESTOR LETTER

To Our Investors:

The purpose of our investor letters is to communicate our recent performance and educate investors on our investment approach.

We will not be posting our investment thesis for each position, but we are always happy to answer questions from our investors. We do, however, share some of our research publicly on our website lucacap.com.

Additionally, we write the occasional paper that provides a more in-depth overview of our thinking on important topics, such as our recent paper on *Methods of Measuring Value.* We will not be reposting these papers in our investor letters; we prefer to keep these letters brief and informative. If you wish to receive updates when we publish a paper, please visit our website and subscribe to our distribution list.

4Q20 Results

During the fourth quarter of 2020, the Durable Growth Portfolio increased 18% net of fees. This compares to the overall increase, including dividends, for QQQ and SPY of 12.9% and 12.1%, respectively. Since inception on October 1, 2019, the Durable Growth Portfolio returned 131.2% net of fees, compared to QQQ and the SPY of 67.7% and 29.1%, 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%	4.88%.	2.30%.	10.03%	112.1%	48.6%	18.4%
Cumulative return since inception													131.2%	67.7%	29.1%

Brief Comments On 2020

As an investor, when returns are poor in your investment portfolio, you might not be as dumb as you think. And when things are going exceptionally well, you are likely not as smart as you think. Good luck and bad luck play a role in short-term results and there is no way to eliminate the element of chance in common stock investing.

This past year we experienced both extremes of bad luck and good luck in the economy and stock market. While there is a possibility of a pandemic every year, the probability is extremely low. It was incredibly unlucky that we had a pandemic that forced our country to make tough decisions about social distancing and closing businesses. Real GDP decreased -3.5% in 2020 as a result.

Despite the weakening economy, the S&P 500 index (SPY) increased over 18% and the Nasdaq 100 index (QQQ) increased nearly 49%. Many investors and observers were shocked by the swift sell-off in the market in March, then equally puzzled by the rapid rebound. The S&P 500 rose 20.5% in Q2 2020 despite it being one of the toughest quarters in history for the American economy, with a GDP decline of -31.4% and unemployment peaking at 14.7%.

The actions by our government in response to the economic crisis we faced were swift and substantial. The trillions of dollars in stimulus, combined with low interest rates and confidence that the economic challenges were short-term, created optimism in the stock market.

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"The greater the uncertainty, the more people are influenced by the market trends; and the greater the influence of trend-following speculation, the more uncertain the situation becomes."

–George Soros (*Soros: The Most Influential* Investor by Robert Slater, 2009)

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The dominating trends in the market the last three quarters of 2020 were remote work and e-commerce. Zoom became a household name and the hottest stock, with good reason: revenue accelerated to 355% year-over-year growth in its quarter ending July 31, 2020.

Many other companies also benefited from this shock to our way of living and doing business, but high growth companies in general became popular with investors, resulting in significant valuation-multiple expansion in our primary areas of focus: Software, Cybersecurity, Digital Payments, Digital Advertising, and Health Technology.

While we project high returns for our companies over many years and they are of exceptional quality, the returns we had projected were pushed forward last year and we got the returns much earlier. In other words, we benefitted by being in the right spaces at the right time. Earning triple-digit returns in the stock market without leverage or extreme concentration is an anomaly. While we are proud of our results and happy that our investors reaped the benefits, we must candidly admit that fortune played a major role. We may never have another year with returns as high as we earned this past year.

Comments on Conditions Today

As the year progressed, we got increasingly uncomfortable with valuations in certain parts of the market and our forecasted IRRs for some of our positions no longer met our target IRRs for the portfolio. We therefore trimmed or exited some of our positions and found more attractive opportunities in health technology. At the end of the year, five of our top ten positions were health technology companies.

The healthcare industry has been resistant to major change, but the impact of COVID-19 has accelerated the demand for disruptive technologies, including telehealth. There is a growing supply of companies being funded by venture capitalists and we are excited about the possibilities in the future, not just from an investment standpoint, but from a quality-of-living standpoint. This will almost certainly result in a few health tech companies becoming worth hundreds of billions of dollars in the future.

Our 2021 Goals

Our goals are simple, but not easy. Our goal in 2021 is the same goal we will have every year: to find 1-2 outstanding companies we want to own long-term and make them meaningful positions.

We want to own the emerging winners in fast-growing spaces. Current areas of focus are Software, Digital Advertising, Digital Payments, Cybersecurity, and Health Technology. We are in a technology revolution that will not end soon and will continue to evolve. Emerging areas we are optimistic about long-term are Telehealth, Artificial Intelligence, the Internet of Things, Space Exploration, Connected Fitness, and Autonomous Vehicles.

Investment Framework: QGV

The Durable Growth Portfolio was a long time in the making.

I (Michael) became passionate about investing in 2000, the year after I graduated high school. It was an interesting time; unlike anything we have ever experienced in the stock market before then or since. We were coming off the greatest bull market our country has seen, when from 1975 – 1999 the S&P 500 returned 14.5% annually, with only 3 slightly negative years out of the 25. This was the prime of Warren Buffett, Peter Lynch, George Soros, Michael Steinhardt, Julian Robertson, and many of the other great investors.

Things changed in 2000 and the Nasdaq plunged over -39% in 2000, -21% in 2001, and -31% in 2002. Welcome to investing!

Living off student loans, I had no savings in college. After graduating I started investing and I began managing money for family members in 2004. Then in 2007 the residential real estate market started to crack, resulting in a financial crisis, which led to an over 50% price decline in the S&P 500 from May 31, 2007 to February 28, 2009. For those not counting, that was 21 months of steady declines in the stock market, where half your money evaporated on paper. It was very painful for those that experienced it. It took until February 2013 to get back to break-even in the S&P 500 from the peak in May 2007.

The crisis we experienced in the stock market in 2020 was very painful for a few weeks, but then the market started to recover, and the S&P 500 finished the year up over 18%. The pain did not last long.

Warren Buffett and Charlie Munger are my biggest influences as an investor. Like many other followers of Buffett, I took his criticisms of technology investing to heart and considered it highly speculative. Buffett says to stick within your circle of competence, but 19-year old's do not have a circle at all. The advice is sound, but an important component is omitted: investors should build their competence in the areas with the best future opportunities. An investor that builds his expertise in oil & gas or brick-and-mortar retail will have quite different long-term results than someone who focuses on software, health technology, and cybersecurity.

It pains me to say this, but it took me far too long to come to this realization. I started my own independent advisory business in 2011, with an emphasis on value investing. My track record was great the first four years, but 2015 was a challenging environment for value investing. I did a lot of soul searching that year and discovered the inconsistency between value investing and long-term investing. Traditional value investing is buying a business less than its true worth, then hoping others see the mispricing soon and push the price up to its true worth. However, unless the company is increasing its intrinsic value at a high rate, there is no reason to continue owning a company that is now "fully-priced".

Obviously, I am a slow learner, but I am happy I came to that realization in 2015 because the environment for value investors has not gotten any easier the past 5 years. In 2016, I met my partner in the Saga Portfolio, Joe Frankenfield. He just left his job and was planning to start a fund. I reminded him that raising capital as a 29-year-old with no track record and no connections is not easy and that I already had clients and the infrastructure in place. Joe's biggest influence as an investor is also Warren Buffett so we clicked right away, but it was his passion, discipline, and commitment to constant improvement that made me believe in him and want to partner.

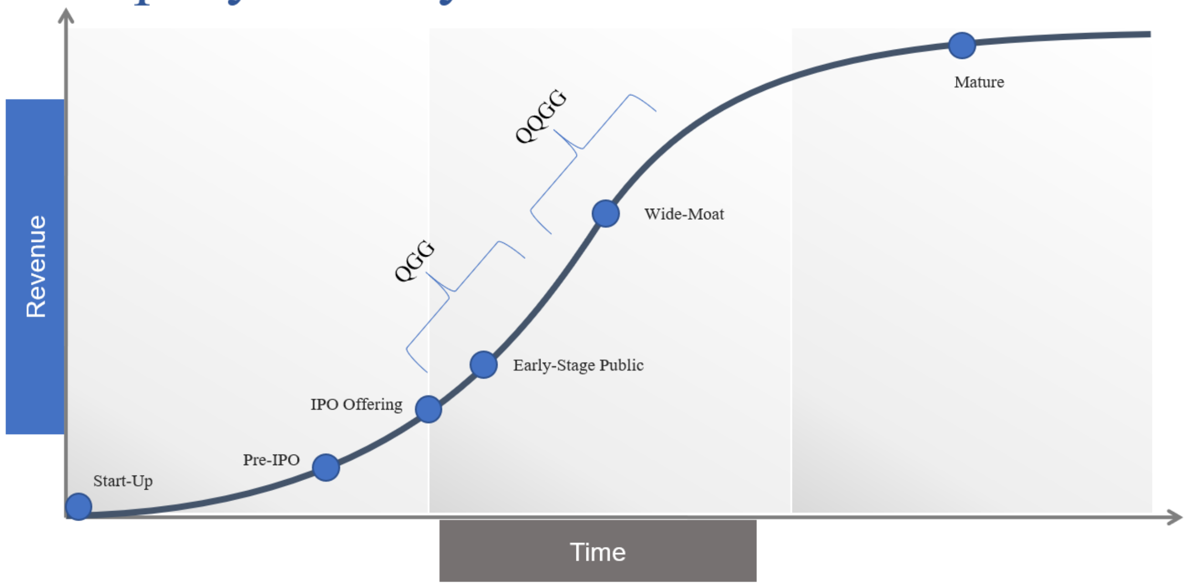
We launched the Saga Portfolio in January 2017 and around the same time we connected with a Cleveland businessman and investor, Umberto Fedeli. His roots were also in value investing and he had made the occasional mistake buying value traps. He said he wanted to avoid value traps by focusing on Quality, Growth, and Value.

The three of us spent nearly a year studying Umberto's trades over the prior decade, seeing what worked, what did not, and why. We categorized stocks using Quality, Growth, and Value. However, it quickly became apparent that this was an oversimplification. A regional bank was good quality, but it was certainly not the quality of Google. Therefore, we assigned the regional bank Q and Google QQ.

We then ran into the same obstacle with growth. One company was growing revenue high single digits, so we gave it G, while another company was growing revenue 25%, so we gave it GG.

We ended up with four main categories of stocks. One was QGV, which investors would only want to buy when they are severely mispriced. Another was QQG, which are wide-moat companies, but only growing revenue in the single-digits. The third category was QGG companies, which were typically younger companies without much in earnings, but growing revenue over 25% annually. The fourth category were QQGG companies and these are among the greatest companies on the planet—there are not many of them.

Company Life Cycle



QQGG are the best businesses on the planet. These are wide-moat companies, with outstanding CEOs, and growing revenue at 15% or above. We call them "wide-moat growth" companies and there are only a few dozen on the planet.

QGG are companies that are younger and rapidly growing. They are the disruptors. They typically have 25% revenue growth or above and it is sustainable for at least the next 5-10 years.

QQG are companies with wide-moats and great CEOs, but revenue growth is under 10%. These companies make up most of the Dow Jones Industrial Index and S&P 500.

QGV are quality companies, with revenue growth below 10% and opportunity for valuation multiple expansion.

Over a company's life cycle, the good companies from "start-up" through "early-stage public" are QGG at best. Then they hopefully become QQGG companies. After that, they inevitably become QQG companies as they mature and growth slows. Our primary goal in the Durable Growth Portfolio is to find the QGG companies that will be future QQGG companies and find them early.

Within the QGG space, we break companies into three tiers:

- Tier-1 companies are those that can become future QQGG companies or have some significant competitive advantages. The visibility and durability of these companies are high. These are often low risk if you own them long-term.
- Tier-2 companies are those that have durable growth, but there is lower visibility when it comes to the future competitive dynamics.
- Tier-3 companies are companies that are smaller players in their space, at a competitive disadvantage, or have low visibility. These are often high risk.

Cornerstone of Our Approach: High Visibility and Durability of Growth

We want to own companies with high visibility and durable growth. By visibility, we mean that there is a narrow range of probable outcomes for the competitive dynamics within the company's space over the next 5 – 10 years. These are companies doing the disrupting, gaining market share, and emerging as the winners in their space.

We seek to own companies that have existing competitive advantages and are building moats. Moats not only make the visibility higher, but a moat is required for growth to be durable and to sustain high returns on invested capital.

Companies with extremely large TAMs are our primary target, but we also invest into companies with smaller TAMs in winner-take-all or winner-take-most markets with secular growth.

We prefer founder-led companies or ones run by a uniquely talented CEO. Companies that recruit and attract the best talent tend to prevail.

We want to own companies with a mission-driven culture. Companies that are obsessed with delighting customers tend to win and retain customers.

Focus on the Long-Term

We cannot earn high returns *all the time*, but we only have one purpose and that is to earn high returns *over time*. It is inevitable that we will have years of poor absolute and relative results, we encourage our investors to focus on the long-term results.

Our Sweet Spot

Companies with a $2 billion to $20 billion market cap are in the "sweet spot" for us. In this regard, not having the burden of billions in assets under management is an edge. We do invest into companies outside of this range when attractive opportunities are available.

Risk Management
We view risk differently than others. Volatility is short-term risk; it is only relevant if you are going to make withdrawals soon. The stock market is a volatile place and we make no attempt to manage volatility. In fact, it is almost certain we will be more volatile than the S&P 500 and Nasdaq 100. Our goal is to earn high long-term returns and if we achieve this goal, the month-to-month volatility will be complete irrelevant to us in hindsight.

We believe the best risk management occurs at the individual stock level, not from excessive diversification or hedging. If we could make money hedging, we would happily do it, but for most investors hedging lowers long-term returns.

Allocation
Investment success is largely determined by judgment and investing heavily when there is a low-risk/high-reward opportunity. Our goal is to make a few high-quality purchases a year, not dozens of purchases. We cannot identify and own all the top performers. Nor do we chase hot stocks or areas due to a fear of missing out. We have a saying around the office: You only have to be right about the companies you buy.

Allocation is the "art" part of investing. There is no scientific way to determine the correct allocation of a position. We target 15% - 20% as a top position and it can become a larger percentage if it outperforms the rest of the portfolio.

When we have a few wonderful ideas, we may own as few as 10 positions and when we have many good ideas, such as during a market pullback, we may have up to 30 positions. We want to avoid being concentrated for the sake of concentration and over-allocating to ideas just because we are low on ideas. We do not want to make a position 15% that should only be a 5% position in normal times, merely because we are short on ideas.

We will take starter positions of 1% - 2% in companies that have tremendous upside potential. We may also find an area we want to invest into, but it is not clear who the winner is yet, so we will buy a basket of a few positions in the companies that have the highest probability of emerging as the winner. Once the winner starts to become apparent, we may add to the winner and sell the other companies.

Below are valid reasons for selling a company we initially wanted to own indefinitely:

- If Revenue, Free Cash Flow, or EPS growth have decelerated considerably
- If we believe growth will decelerate considerably due to management changes, competitive pressures, secular industry headwinds, or a poor acquisition
- If the valuation gets too out of hand and we estimate future returns do not meet our required rate of return
- If we find a significantly better opportunity and we need cash to fund the purchase

Organizational Structure

In our first annual letter, we want to briefly explain our operational structure and the rationale for being structured this way.

One lead portfolio manager. One person will always be the ultimate decision maker, investment-by-committee does not work as well. However, teamwork is important to find new ideas, question each investment, and for risk management. Having different viewpoints improves the quality of research, due diligence, and ultimately the decision making.

We use separately managed accounts. There are several reasons we prefer this structure:

- It allows us more flexibility with who we can take on as clients. Unlike the traditional private fund structure, we are not limited to 100 investors and only accredited investors.
- Clients have 24/7 access to their account online, creating complete transparency.
- Monthly statements and tax statements come directly from the broker—no audit required, third-party administrator, or K-1.
- No lockup or redemption period required due to liquidity concerns.

Low fees of 1.5% of AUM annually and no performance fee. We strive to provide industry leading net annual returns and the more we charge in fees, the harder it is to provide excess returns.