To: Clients of Eagle Point Capital
From: Matt Franz and Dan Shuart, Principals

Subject: Fall 2023 Portfolio Update
Date: September 30, 2023

"Learn from the mistakes of others. You can't live long enough to make them all yourself."

– Eleanor Roosevelt

"You don't have to pee on an electric fence to learn not to do it."

– Charlie Munger

One obvious but overlooked way to succeed is to learn from the mistakes of others. It's expensive, time consuming, and unnecessary to reinvent the wheel.

The aviation industry does this best, which is why flying is the safest mode of transportation. Researchers at Harvard calculated that the odds of dying in a commercial airline accident are one in 11 million. The odds of dying in a car accident are one in 5,000.

Flying is safer because crashes and near-misses are rigorously investigated and studied. The findings are codified into regulations for manufacturers and checklists for pilots. By comparison, investors are winging it (*pun intended*).

In *The Checklist Manifesto* Atul Gwande wrote, "under conditions of complexity, not only are checklists a help, they are required for success." Checklists provide structure, consistency, and discipline. Most importantly, checklists ensure that experts do not overlook essential steps due to overconfidence.

Overconfidence is a serious problem in investing. A string of successes can lull an investor into feeling invincible. An overconfident investor may lower their investment standards or break with their tried-and-true approach, usually to their regret.

A checklist is not a panacea. It is only as valuable as the care and diligence it is built with. "Good checklists are precise," Atul Gwande explains. "They are efficient, to the point, and easy to use even in the most difficult situations. They do not try to spell out everything – a checklist cannot fly a plane. Instead, they provide reminders of only the most critical and important steps – the ones that even the highly skilled professional using them could miss. Good checklists are, above all, practical."

Eagle Point's checklist has been evolving since we started the company. It's a living document that will continue to evolve. We built it by studying our own successes and failures, as well as those of like-minded investors. We've adopted Singapore's Lee Kuan Yew's attitude: "figure out what works and do it."

The result codifies our investment framework. It's what we've found reliably works. The purpose of our checklist is to make our results as consistent and repeatable as possible. Mistakes are inevitable but our checklist should reduce their frequency and severity.

What follows is a list of qualities Eagle Point looks for in each investment. Each need not be present to the same degree. There can be puts and takes, but all must be present in some capacity.

1. A simple, predictable, and profitable business that we understand.
2. A business in "replication mode" whose future will resemble the past.
3. A dominant position in a rational and consolidated or consolidating industry.
4. Limited exposure to extrinsic factors outside of the company's control.
5. High returns on incremental invested capital.
6. A demonstrated and enduring competitive advantage.
7. A resilient balance sheet.
8. A clear, consistent, and rational approach to capital allocation.
9. Incentives that align management with long-term shareholders.
10. A price which affords a margin of safety.

Our checklist will filter out lots of good investments, and that's okay. Its primary purpose is to filter out bad investments. As investor Joel Greenblatt says, "If we avoid the losers, the winners take care of themselves."

Below we will provide some commentary about each item on our list.

1. A simple, predictable, and profitable business that we understand.

There are no points for difficulty so we invest in simple businesses that we can easily grasp. We avoid businesses and industries that are rapidly changing. If we don't understand how a business works we're liable to be shaken out of the stock at the worst possible time.

We consider a business predictable when we understand its likely five or ten year trajectory. We do not try to predict a company's earnings quarter to quarter or year to year.

We invest in profitable businesses that consistently produce free cash flow. Free cash flow allows a business to reinvest in growth and return profits to shareholders through dividends and buybacks. Without consistently positive free cash flow a business is dependent on capital markets for funding.

2. A business in "replication mode" whose future will resemble the past.

Good businesses usually remain good and bad businesses usually remain bad. We don't try to figure out when a bad business will turn into a good one. We wait for a business to demonstrate all of the qualities on this checklist before we invest.

We invest in businesses whose future will resemble their past. This means that they have demonstrated attractive unit economics, a durable competitive advantage, and a long runway for continued growth.

3. **A dominant position in a rational and consolidated or consolidating industry.**

We invest in monopolies, duopolies, oligopolies, and businesses with an otherwise dominant position within their industry. A dominant position usually provides a company with scale advantages over its competition.

Industries usually become more rational as they consolidate. Rational industries maximize profits instead of market share and compete on quality, not price. Supply is stable and does not outpace demand.

4. **Limited exposure to extrinsic factors outside of the company's control.**

Businesses are most predictable when they are masters of their own destiny. Companies levered to commodity prices, like oil, or financial prices, like interest rates, are hard to predict. We avoid businesses subject to onerous, uncertain, or rapidly changing regulations.

5. **High returns on incremental invested capital.**

A company's growth rate is the product of its reinvestment rate and incremental return on capital. Higher returns on incremental invested capital produce faster growth.

Durably high returns usually indicate that a company has a competitive advantage insulating it from competition. High returns also suggest low capital intensity, which makes a business less susceptible to inflation.

6. **A demonstrated and enduring competitive advantage.**

A competitive advantage protects a company's profits from competitors in the same way that a moat protects a castle from marauding armies. Without a "moat," excess profits would be competed away. Competitive advantages can take many forms. A few examples are: economies of scale, network effects, high switching costs, irreplaceable assets, brand loyalty, and low cost production. An enduring competitive advantage is tightly related to a business's predictability.

7. **A resilient balance sheet.**

To finish first, you must first finish. Survival is paramount. A resilient balance sheet allows a business to weather the economy's inevitable ups and downs from a position of strength. We invest in businesses that can invest through a downturn when prices are most favorable.

8. **A clear, consistent, and rational approach to capital allocation.**

It's not enough for a company to make a profit. The company needs a capital allocation framework that ensures each dollar of profits produces at least a dollar of value for shareholders. We invest in businesses that clearly articulate their capital allocation priorities. Changes in capital allocation are often a catalyst for us to buy or sell an investment.

9. **Incentives that align management with long-term shareholders.**

Charlie Munger once said “Show me the incentive and I’ll show you the outcome.” We invest alongside managers who have skin in the game and interests aligned with ours. We don’t invest with empire builders who pursue growth at any cost. Good incentives are tied to long-term free cash flow per share and return on invested capital.

10. A price which affords a margin of safety.

A margin of safety is the difference between the price we pay and the intrinsic value of what we’ve bought. In *The Intelligent Investor* Benjamin Graham wrote “The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, and nonexistent at some still higher price.”

Buying businesses for less than they’re worth leaves room for our inevitable errors. We never want to buy a business priced for perfection. Our goal is to avoid losing money even when we’re wrong.

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Attached to this letter, we’ve written more about each of our investments to explain why we own them, how they’ve performed, and our expectations for their future. We also explain the recent changes we’ve made to our portfolio.

But first, we’d be remiss if we did not **thank you for your continued support and trust.** Investment managers can only afford to be as patient as their clients allow. Your patience and trust contribute as much to our success as anything we do at Eagle Point Capital.

We are grateful for your support for EPC’s long-term investment approach. Our clients have proven to be exceptional and stoic investors, which provides us all with a significant competitive advantage. We are honored that you entrust us with your capital, and we are proud to be your investment partners.

Please contact us (**matt@eaglepointcap.com** or **dan@eaglepointcap.com**) with any questions about your account or your investments.

If you know any like-minded investors who would enjoy this letter, please forward this to them or put them in contact with us.

You can expect to hear from us again on or around April 1, 2024, with another portfolio update. In the meantime, you can read our previous letters and blog at www.eaglepointcap.com. We encourage new readers to join our mailing list to receive future updates.

Best,

Matt and Dan

The portfolio specific portion of this letter is for current and prospective clients only. If you'd like to invest with us please contact us (info@eaglepointcap.com).

The Rule of Three

Francois Rochon of Giverny Capital is one of the investors we admire most. He coined the Rule of Three, which we've decided to adopt as our own. It is a rule of thumb based on empirical stock market data that will help level-set expectations.

1. One out of every three years, the stock market will decline by 10% or more.
2. One out of every three stocks we buy will not perform as expected.
3. One out of every three years, we will underperform the index.

Every few years, people forget that stock prices crash every few years. This is good news since crashes produce bargains, and bargains tend to produce higher returns. When we think and act like long-term business owners, volatility becomes our friend and not our foe.

Fundamentals

Attached is a copy of a short memo outlining our fundamentals. It explains our goals and methods. Investing is simple but not easy, and success is made or lost on the application of fundamentals.

Once, after winning two consecutive national championships, the Green Bay Packers lost a game due to sloppy play. Coach Lombardi called a meeting the very next day. When all the players were assembled, Lombardi held a football high up in the air and declared, “Gentlemen, this is a football!” From the back of the room, running back Paul Hornung shouted back, “Coach, can you slow down?”

In investing, as in football, success is made or lost on the application of the fundamentals.
This document sets forth the fundamental operating principles of Eagle Point Capital. Through the up and down markets ahead, we will always return to the principles below to inform our attitudes and actions.

- Our objective is to avoid the permanent loss of capital while maximizing the increase in long-term, after-tax purchasing power of our funds. Put another way, we aim to build an indestructible long-term compounding machine.

- To achieve this objective we seek to make concentrated investments in businesses that:
  (1) We understand.
  (2) Have a demonstrated and enduring competitive advantage.
  (3) Have a resilient balance sheet.
  (4) Have honest and able management who run the company for the benefit of shareholders.
  (5) Can be purchased for a reasonable price that affords a margin of safety.

- In other words, we aim to purchase, at a rational price, interests in easily-understandable businesses whose earnings are virtually certain to be materially higher five, ten, and twenty years from now. We prefer cockroach-like businesses — very hardy and almost impossible to kill.

- We think independently and do our own research. We don’t rely on the opinions of analysts or journalists, both of whom may have different motivations than ours. We rely primarily on S.E.C. filings for information.

- We do not diversify excessively. Good investments are hard to come by and we would rather concentrate our capital into our best ideas than spread among many mediocre ones. We typically own six to ten businesses and put 10% of our capital, at our cost, into each.

- We think and act like business owners. As owners, we focus on the fundamentals of the business and do not obsess over price fluctuations. When possible, we use periods of unjustified pessimism to purchase high quality companies at attractive prices. Likewise, we prefer to use periods of unjustified optimism to sell companies for more than we feel they are reasonably worth. The market is our servant and not our master.

- The best way to measure our success is to compare Eagle Point Capital's return, after fees, to the S&P 500's total return (including the reinvestment of dividends) over five-year periods. Measurement over a shorter timeframe may reflect luck more than skill. The S&P 500 is our benchmark because it is widely followed, offers the potential for large, low-cost investments, and, we expect, will produce satisfactory long-term returns. Over time, we expect good relative returns to the S&P 500 to become excellent absolute returns.

- All accounts are managed *pari passu*. Clients may elect one of two fee structures:
    1. A two percent annual fee on assets under management charged quarterly in arrears.
    2. 25% share of profits in excess of a 6% hurdle rate, subject to a high water mark, charged annually in arrears. This option carries no management fee.

- Clients will receive a letter twice a year detailing what they own and why they own it. Our reports will be candid, emphasizing the positive and negative factors important to appraising intrinsic business value. Our guideline is to tell you the business facts we would want to know if our positions were reversed. We owe you no less.

- Eagle Point Capital is not in the business of predicting the general stock market or business fluctuations. If you think we can do this or that it is essential to an investment program you would be best suited looking elsewhere.

- We cannot guarantee results to clients. What we can and do promise is that:
    - Our investments will be chosen on the basis of value, not popularity;
    - We will attempt to bring risk of permanent capital loss (not short term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each investment; and
    - We have virtually our entire net worth invested alongside Eagle Point Capital's clients. We eat our own cooking.

Many of you who are already familiar with Eagle Point Capital may feel, like Paul Hornung, that this material is unduly repetitive. However, we would rather have many bored clients than a single client with any basic misconceptions. As Charlie Munger says "A majority of life's errors are caused by forgetting what one is really trying to do." A firm grasp of our fundamental operating principles will help us stay the course in the future.