To: Clients of Eagle Point Capital
From: Matt Franz and Dan Shuart, Principals
Subject: Spring 2024 Portfolio Update
Date: March 30, 2024

"Bull markets climb a wall of worry; bear markets slide down a river of hope."

– Wall Street proverb, Anonymous, 1950s

In investing, as in life, the coast is never clear. Certainty only exists in hindsight. Hindsight makes outcomes seem obvious and inevitable, so it's easy to forget how murky the future *always* appears. The best time to buy is always when the news looks ugliest.

Do you remember October 12th, 2022? We sure don't. The S&P is up 44% since then. Here were the *Wall Street Journal's* headlines that morning:

- "Stocks Slip After Fed Minutes, Inflation Data"
- "The Federal Reserve Slams the Brakes and Risks Spinning Out"
- "Stocks Move in Lockstep as Fed's Rate Increases Show No Mercy"

How about March 23rd, 2020? The S&P is up 130% since that day. Again, the *WSJ* headlines:

- "Senate Fails to Advance Coronavirus Rescue Package for Second Day"
- "Mortgage Firm Struggles to Meet Margin Calls as Market Turmoil Continues"
- "Stock Market Meltdown's Historic Velocity Bruises Investors"
- "U.S. Stocks Drop Despite Fed's Latest Stimulus Move"
- "The Fed Steps Up but Can't Save Economy on Its Own"

Here's March 9, 2009. The S&P is up about 600% since then.

- "Tech Drop Takes Down Stocks"
- "Nikkei at 26-Year Low"
- "Unemployment of 8% is highest in 26 years"
- "New Fears as Credit Markets Tighten Up"

Let's end with something more recent: October 27th, 2023 – not even six months ago. The market has rallied over 25% since then.

- "Stocks Log Another Weekly Loss as Market Mood Darkens"
- "Inflation Trends Keep Fed Rate Hikes on Pause"
- "'Disappointed Again': Ad Companies Suffer as Tech Firms Clip Spending"

How many people felt, on any of these days, that the coast was clear and it was THE time to pile into the stock market? Was it obvious at the time that generational returns lay ahead?

The *WSJ's* headlines sure didn't give investors the green light to invest. It would have been much easier to *sell* on these headlines. But selling at any of these junctures would have been a costly mistake.

To avoid cherry picking, let's look at the news during a year where nothing noteworthy happened – the good old days of 2019. Pundits refer to 2019 as the last "normal year," but people were worrying incessantly in 2019, too.

Here is how *Barron's* opened their January 2019 cover story:

> "It was a dark and stormy day. No, we're not referring to the weather, which was perfectly chill for early January, but to the tenor of the conversation at this year's *Barron's* Roundtable, our annual investment talkfest and stockpickathon, featuring 10 of Wall Street's smartest investors.
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> Consider the panoply of problems on which our panelists dwelled: a rising ocean of corporate and government debt, a debilitating trade conflict, fake earnings, tech disruption, political paralysis, the withering of the middle class. Might as well cue the demise of the Western world, which, by the way, also came up for discussion."

That sounds rather bleak. *Barron's* "experts" were girding for a tough year. In 2019 the S&P 500 returned a little over 31%.

Of course there was something big to worry about in 2019: the global pandemic approaching our doorstop. No one was talking about that, though. The biggest, most impactful risks are always the ones that no one sees coming.

There Is Always A Reason To Sell Stocks

In 2016 Morgan Housel published a chart, reproduced below, outlining all of the "smart" reasons to sell stocks during a period where stocks returned 100x *after* inflation.

Source: [Morgan Housel, 2016]

All of the events Housel highlighted were objectively bad. Selling stocks and waiting for the storm to pass would have sounded smart at each juncture, but would have turned out to be dumb. Markets tend to rise over time despite dreary headlines, negative events, and doom and gloom prophecies. Why? People, companies (especially high-quality ones), and nations adapt and evolve.

Case in point: COVID-19.

- On March 11, 2020 the WHO declared COVID-19 a pandemic.
- 250 days later, on November 16, 2020, the FDA found that Moderna's vaccine was 95% effective.
- 28 days later, on December 14, 2020 Sandra Lindsay, a nurse in New York, became the first American outside of clinical trials to receive a COVID-19 vaccine.
- 89 days later, on March 13, 2021, over 100 million COVID-19 vaccines had been administered in the US (in no small part thanks to McKesson).

In almost exactly a year the US solved what initially appeared a hopeless situation. Vaccines typically take 10-15 years to develop, but when the stakes are high people find a way to cut through red tape and get things done. It's a miracle that has happened again and again in America, from the colonists defeating the British to American factories retooling seemingly overnight to build weapons for World War 2.

How Eagle Point Manages Uncertainty

Trying to predict unknowable events and assess when the coast is clear is a fool's errand. It's akin to market timing. We don't try.

We manage uncertainty by owning businesses that can survive and thrive during virtually any environment. We prefer what Allan Mecham calls "cockroach-like businesses": very hardy and almost impossible to kill. They may not be pretty, but they have stood the test of time and will likely be here long after we're gone.

We own businesses with strong competitive positions that can confront uncertainty from a position of strength. For example, businesses with pricing power – those that can raise prices without losing volume, like AutoZone – can navigate a variety of stressors relatively pain free. Labor costs rising? Raise prices. Raw material prices rising? Raise prices. Taxes going up? Raise prices. Pricing power is a great lever to be able to pull and makes being a business owner much more comfortable.

Rather than fearing uncertainty, we embrace it. Uncertainty can create low valuations and low valuations can create asymmetric investment opportunities. Ben Graham taught that "the purpose of a margin of safety is to render the forecast unnecessary." When pessimism is so rampant that valuations already reflect the worst-case scenario, stocks can become a "heads I win, tails I don't lose much" investment.

The next time alarming headlines or "high" stock prices (whatever that even means) give you the urge to sell, **think like a business owner**. This is, after all, what investing in common stocks makes you.

If you owned a collection of 10 local businesses, all with sound economics and durable cash flow, would you be on the edge of your seat waiting for the latest Federal Reserve policy statement to decide whether or not to sell your businesses? Would you sell your town's pharmacy, local Domino's Pizza franchise, or corner convenience store, because Israel is at war with Hamas or because a strong jobs report could lead to higher interest rates? We sure wouldn't, so why do so many people consider selling their minority interest in these same businesses via the stock market?

We like Housel's advice for dealing with a perpetually gloomy outlook where there is always something to worry about: **if something is unlikely to matter five years from now, do not spend five minutes worrying about it today**. Very little ends up passing this test, as the *WSJ* headlines show.

One of our favorite investment scenarios is to buy when a wonderful company encounters a significant but temporary one-time problem. Uncertainty and fear can quickly drive the stock's price down 50% or more. The price may be attractive, but prices never fall in a vacuum. Attractive prices always come paired with a high dose of uncertainty.

When this happens we ask: was it really a one-off event, or is the business model broken? If the business has a strong and strengthening competitive position, we will typically buy. That's what we did when Dollar General tumbled in 2023. Though margins had fallen, the company's long-term competitive position was, as far as we could tell, as strong as ever. If that was the case, its margins were not structurally impaired and would eventually recover, even if that meant waiting several years.

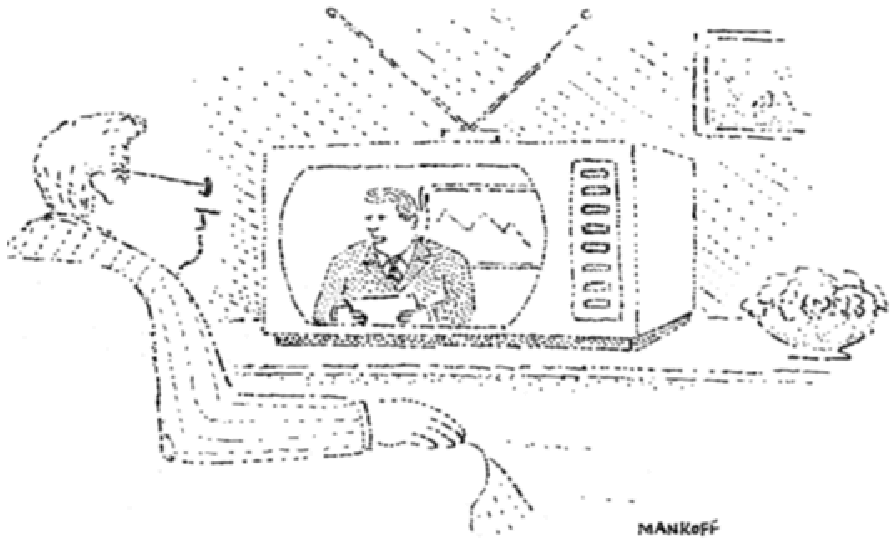
There's a natural tendency to want to wait to buy until the coast is clear. Lots of investors wanted to wait to see DG's margins normalizing before buying. But by the time that happens, prices are almost always dramatically higher. Indeed, Dollar General's stock is up 50% off its lows now that margins are beginning to perk up.

We've had countless investments play out like this, including McKesson, DaVita, and Meta, to name a few. Often there will be no debate among knowledgeable investors that the stock is undervalued. Yet, they won't buy. **Many investors refuse to purchase what they admit are clearly undervalued stocks because they are afraid the stock price might decline further over the next few quarters and they will look foolish.** Fortunately, thanks in large part to our investor base, Eagle Point Capital has not and will not suffer from this phenomenon.

As Seth Klarman has reminded investors, when presented with an attractive price, the correct course is to act, even if it means accepting the chances that the stock will become even cheaper after you've purchased it. In other words, don't wait until the coast is clear.

> *"Sometimes buying early on the way down looks like being wrong, but it isn't. You must buy on the way down. There is far more volume on the way down than on the way back up, and far less competition among buyers. It is almost always better to be too early than too late, but you must be prepared for price markdowns on what you buy."*
>
> – Seth Klarman, *Margin Of Safety*

There is no more clarity today than there was a year ago. There will be no more clarity at this time next year, either. If today's worries clear up they'll be supplanted by the worries of tomorrow. This worrying whack-a-mole reminds us of a cartoon that Howard Mark frequently references.



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Source: [Oak Tree Capital]

The coast is never clear, which is why we like to buy cockroach-like businesses selling for a price that does not require the coast to be clear, now or in the future.

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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 of 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 October 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.