To: Clients of Eagle Point Capital
From: Matt Franz and Dan Shuart, Principals
Subject: Fall 2022 Portfolio Update
Date: October 1, 2022

"The most important investing question is not, 'What are the highest returns I can earn?' It's, 'What are the best returns I can sustain for the longest period of time?"

— Morgan Housel

On September 25, 1990 the Wall Street Journal wrote an article about a New York money manager that dramatically outperformed the S&P 500 in 1989 but drastically underperformed the following year.

> "A year ago, the big New York money-management firm, which runs about $9.5 billion of stock portfolios, was coming off a winning streak. Then, in typically bold fashion, it gambled two-thirds or more of clients' money on a rebound of cyclical companies that are highly dependent on the economy's fortunes — raising its stakes massively in financial, technology and auto stocks.
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> But the rebound was delayed and the bets didn't work out.
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> In the 12 months through August, Bernstein's stock portfolios have fallen by 23.4% and were a stunning 18.4 percentage points behind the market."

The Wall Street Journal could easily run this story today, swapping Bernstein's name for any number of firms. The hype around unprofitable tech stocks, meme stocks, and crypto produced stratospheric returns for many investors in 2020 and 2021. Their fortunes have reversed in 2022. Many have given up all of their gains and then some.

In the Journal's 1990 article Lewis Sanders, Bernstein's president, rebutted:

> "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too."

We couldn't disagree more.

Our philosophy is *consistency beats intensity.* We aim to do a little bit better than average each year, through thick and thin. We do not ask ourselves, "What stock offers the highest returns?" Instead, we ask, "What stock offers good returns with little to no downside risk."

Our focus on protecting the downside means we'd prefer to outperform during "thin" years, like 2022, than "thick" years, like 2021. If we succeed, we will steadily inch ahead of the averages and dramatically outperform over the long term.

Aesop immortalized our philosophy in "The Tortoise And The Hare." Though schools teach this fable to our kids, few investors embrace it. We shouldn't be surprised. In *The Mind of the Market*, F.J. Chu says, "The history of the stock market is the history of forgetting."

We don't think it's realistic to try to string together a series of years of top-decile performance. That requires making consistently bold, concentrated bets that are as likely to succeed as to backfire. Swinging for the fences every day is likely to lead to more strikeouts than home runs.

A combination of far above-average and far below-average years is a recipe for a volatile and mediocre long-term record. The mathematics of compounding makes digging yourself out of a hole difficult — a 50% drawdown requires a 100% return to break even.

We want to avoid digging ourselves into a hole in the first place — to win by not losing. We worry about a return *of* our capital before we worry about a return *on* our capital. If we can avoid losing money, most of the alternatives are good. Our approach isn't flashy, but we think it is effective.

How do we implement this?

First, we prefer simple, predictable, and profitable businesses drowning in cash. Businesses with lots of cash are unlikely to get into serious trouble. We want to own businesses that are like cockroaches — very hardy and almost impossible to kill. We don't care if they're ugly so long as they're resilient.

Second, we pay reasonable prices which afford a margin of safety. We like to buy stocks mired in a cloud of pessimism that face short-term headwinds but enjoy long-term tailwinds. Low prices and low expectations create a low bar for investment success. Investing awards no points for difficulty so we avoid stocks priced for perfection.

Third, we prefer businesses in replication mode whose future is likely to resemble their past. Rather than make bold forecasts about how the world might change, we look for areas where change is unlikely.

Fourth, we use a 10x10 framework to build our portfolio. We buy roughly 10 stocks, each with about 10% of our capital. The 10x10 framework minimizes damage from mistakes, which are inevitable. A mistake or two should never sink our ship. We want to be as resilient as possible to any future state of the world.

Finally, we focus on a sustainable lifestyle. Frantic decision-making, high turnover, and volatile returns are a recipe for burnout for clients and managers alike. The best strategy is the one you can stick with, and we truly enjoy our lifestyle. We avoid stocks that keep us awake at night.

On this point, you play a major role in our collective success. Just as in 2018 and 2020, we have been impressed (though not surprised) at our clients' equanimity during a bear market. Your trust and composure enable us to focus on a dispassionate analysis of business fundamentals. We cannot overemphasize how fortunate we feel to have you as investment partners.

Perhaps counterintuitively, we believe that we will maximize our long-term investment returns if we avoid trying to maximize any single year's return. We will maximize our lifetime investment returns by earning merely good returns consistently. Just as the tortoise beats the hare, consistency beats intensity. While other managers swing for the fences, we're content to hit lots of singles and doubles.

That's not to say there won't be volatility. Although we are pleased by our significant outperformance this year relative to the market averages, bouts of short-term underperformance are inevitable. We cannot affect how the market prices our investments. Equity investors must be willing to accept that the quoted value of their portfolio will decline significantly, perhaps 50% or more, on occasion. While we will do all we can to avoid these periods, they will inevitably occur. Volatility is the price of earning superior returns. All we can do is pay reasonable prices for businesses with stable earnings power that is increasing over time. If our business's earnings march higher, so too will the value of our investments.

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 to you for supporting EPC's long-term approach to investing. 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, 2023, 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