To: Clients of Eagle Point Capital
From: Matt Franz and Dan Shuart, Principals
Subject: Spring 2023 Portfolio Update
Date: April 1, 2023

"The world is full of foolish gamblers, and they will not do as well as the patient investor."

– Charlie Munger

In 2007, an Israeli behavioral economist named Ofer H. Azar wanted to know why so many penalty shots in soccer result in a goal.

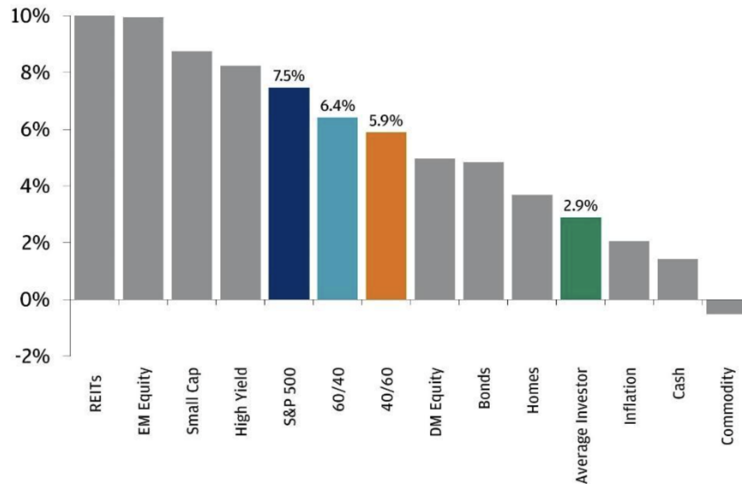
Penalty shots in soccer are difficult to stop. They're taken from 12 yards away, leaving just milliseconds for the goalie to react. To have a chance at making a save, goalies need to guess where the ball will go the moment it is kicked and dive there instantly. They can't afford to waste time on a wait-and-see approach. Most dive right or left, which makes for a brilliant save when it works.

Azar wanted to know whether goalies should dive left or right. He found that goalies saved 14% of shots when they dove left, 13% when they dove right, and 30% of shots when they stood unmoving in the middle of the goal. Ironically, it wasn't heroic dives to the left or right that proved most effective. Simply standing still in the middle of the goal stopped the most shots. The goalies that could stand and do nothing saved 2-3x more goals in these pressure packed moments.

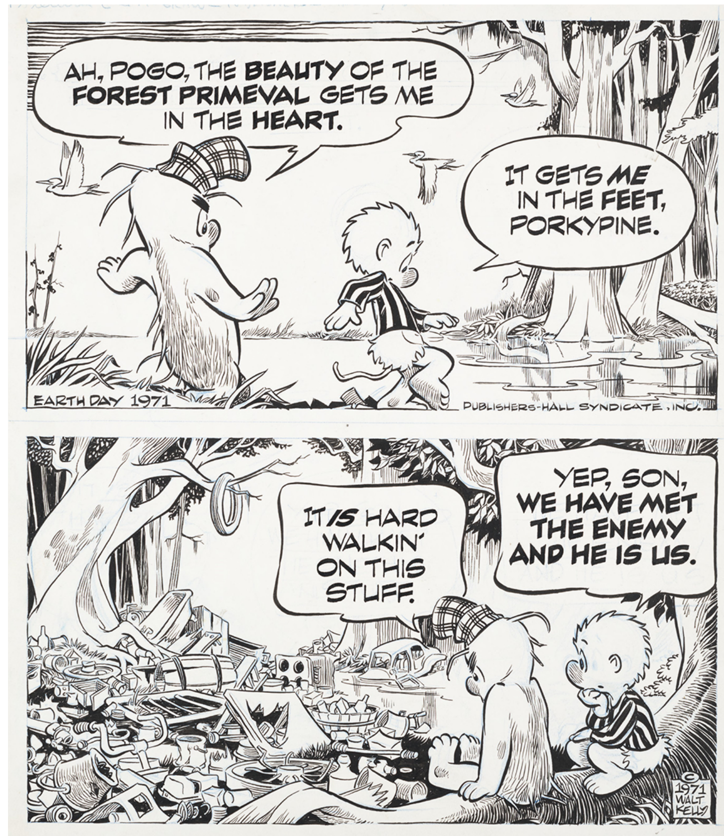
Goalies and investors alike could learn a lot from Vanguard founder Jack Bogle, who chided **"Don't just do something, stand there!"**

Investors, like goalies, get wound up from the excitement, panic, and fear of volatile down days in the market and often dive spur of the moment into cash, planning to get back in when the coast is clear. These erratic movements cost them a lot of money that could have been saved by standing still.

Data shows that individual investors as a group perform significantly worse than passive market indices because they jump in and out at the worst times. From 2001 through 2020, the S&P 500 returned 7.5% annually while mutual fund flows show that the average investor only earned 2.9%.



The 10 year stretch to 2021 was just as disappointing. The S&P 500 gained 16.6% per year and the 60/40 portfolio gained 11% but the average investor only earned 8.7%. "We have met the enemy, and he is us."

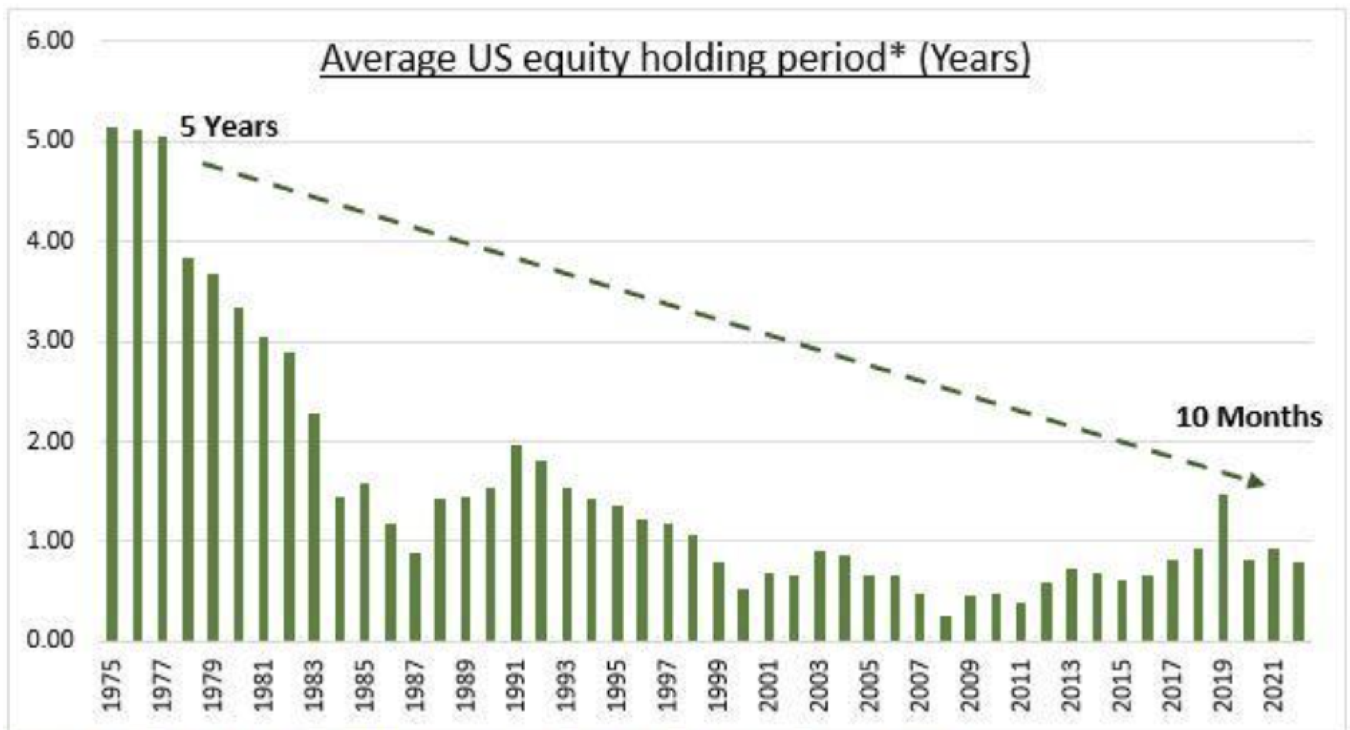


Why do investors consistently underperform over such long periods of time? Investors fear volatility and tend to sell after a big down move. The market's biggest up days tend to cluster just after the market's biggest down days and missing them has staggeringly high opportunity costs.

Between January 2002 and January 2022 the S&P 500 gained 9.4% per year. Missing the best ten days over that twenty year period nearly halves the S&P's annual gain to 5.2%. $100,000 would grow to $275,000 instead of $603,000. **Too much activity would have a $328,00 opportunity cost.**

The market's best days cluster right after its worst days. Seven of the ten best days over the last twenty years occurred within 15 days of the ten worst days. Investors that sell after one of the ten worst days have a 70% chance of missing one of the ten largest up days. Therefore, the only way to guarantee capturing the ten best days is to remain invested and stomach the ten worst days.

Despite the widely acknowledged fact that it's best to be a long-term investor, investors are becoming increasingly short-term oriented. Since 1975, the average holding period for a stock has dropped from five years to ten months. The gamification of investing, 24/7 news cycle, social media, and ease of trading have all contributed to increasing short-termism.



Source: WFE, IMF. *NYSE and NASDAQ market capitalisation divided by total turnover value

At EPC, we believe that stomaching volatility is the cost of earning attractive returns. Volatility is inevitable because humans tend to move in herds. Charlie Munger's story explains it best:

> A teacher asks a class a question: There are 10 sheep in a pen. One jumps out, how many are left? Everyone but one boy said 9 are left. That one boy said none are left. The teacher said "you don't understand arithmetic" and he said: "You don't understand sheep."

We don't know if that's true of sheep, but it is true of investors.

Market "corrections" (10%+ decline) cause a lot of anxiety but happen in more than half of years. 75% of those years still end up with a positive total return. It's a coin toss whether or not stocks go up on any given day, but 80% likely stocks go up over three years. Over 20 years, U.S. equities have never declined in value. This is why it pays to be a long-term investor – the odds are on your side.

The economy is always moving towards a recession, we just don't know when. As the joke goes, economists have correctly predicted nine of the last five recessions. Famed investor Peter Lynch once observed that "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

EPC's approach to volatility, uncertainty, crashes, pandemics, inflation, wars, and bank runs is to prepare, not to predict. We buy undervalued, simple, predictable, and profitable businesses that we understand and hold them so long as their prospective returns look better than our next best idea. We look to our businesses' audited financial statements, not their stock prices, to understand how they are performing. We don't jump the fence just because we saw another sheep do it.

We don't need to predict inflation because we always aim to own high ROIC businesses with pricing power. These businesses are the best to own during bouts of inflation, as well as during normal times.

Similarly, we don't need to predict recessions because we always aim to own businesses with strong balance sheets that don't rely on capital markets for funding. Recessions are inevitable, so we're *always* prepared for one.

Soccer goalies are under the gun and on the clock to make a big play whenever there's a penalty shot. Investors are not. Investing is like playing baseball with no called strikes. Investors can stand at the plate all day waiting for a fat pitch to swing at. That's why Warren Buffett says, **"The stock market is a device for transferring money from the impatient to the patient."**

Our portfolio is designed to create a high bar to activity. If we've prepared properly, we don't need to do anything just because there's a recession, inflation, or higher interest rates. When we properly prepare, we enjoy the luxury of standing pat, owning high quality businesses, and

waiting for the next fat pitch. Fear creates volatility and volatility creates mispricings. That's why volatility is our friend, not our foe.

Napoleon's definition of a military genius was "The man who can do the average thing when everyone else around him is losing his mind." We think this applies to investors too.

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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 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 October 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

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