January, 2020

Dear Partners,

Since inception Laughing Water Capital ("LWC") has returned 93.6% net of all fees, equivalent to an 18.4% compound rate of return. For 2019, our portfolio returned 20.9% net of all fees and expenses. Please check your individual statements as results may vary. Ordinarily this rate of return would be considered excellent, but when the SP500 returns 31.5% and the R2000 returns 25.5%, it is hard to not be frustrated with our results. As always, LWC makes no attempt to track the indexes, and thus our performance will frequently diverge, sometimes to our benefit, and sometimes to our detriment. In a year when greater than 90% of SP500 returns came from multiple expansion, our relative underperformance should not be a surprise. As a reminder, our strategy is specifically focused on purchasing shares in good businesses led by incentivized management teams while they are dealing with some sort of optical, operational, or structural problem that we deem to be temporary. As our management partners steer our businesses past their problems, we expect to benefit from the dual tailwinds of operational improvement and multiple expansion. However, we should not expect to benefit from multiple expansion until the problems have been addressed, thus several of our companies were not aided by the predominant force that drove the broader markets in 2019.

Additionally, our portfolio suffered on a relative basis because our portfolio is significantly more defensive than the indexes. Last year I began to intentionally reduce our portfolio's correlation with the broader indexes by pivoting more toward special situation / event driven investments, as well as by slightly reducing our net exposure. Simply stated, when the indexes are roaring, correlation isn't a bad thing, and maintaining a more defensive stance was a relative drag on our performance. Again, this may be frustrating, but we are running a marathon, not a sprint, and I believe our long-term interests are better served by seeking out anomalous, uncorrelated investments rather than attempting to match the indexes.

Despite these recent stock price related frustrations, for the most part our management partners are capably steering our businesses toward increased success. In fact, a large portion of our portfolio that languished on the year is invested in businesses that have already made undeniable fundamental improvements, which the market will not be able to ignore forever. I believe these investments represent embedded value, and they position us well for the future.

Conversely, reviewing the broad market at present reveals that the gap between the SP500 and profits is at record wide spreads, which implies that either earnings need to move up substantially, or stock prices need to come down. I am not of the view that a recession is on the immediate horizon or that now is the time to panic, but when one considers that the gap between CEO confidence and consumer confidence is also at record wides, taking the view that SP500 profits will rocket higher and backfill valuation support for the index does not appear conservative.

Over time as our uncorrelated investments work out, I believe we will recapture recent lost relative performance as the embedded value within our portfolio is realized. Additionally, I have been building several new positions that I think will appreciate significantly in the years to come. We are long term investors, and our strategy of focusing on good businesses that are dealing with temporary problems will always work in the long term, assuming it is properly implemented. For this reason, almost the entirety of my and my family's wealth is invested in our strategy, and we have recently made the largest addition to our investment in LWC since inception.

Winners, Losers, Patience, and Opportunity Costs

Every year in our portfolio there are stocks that are winners, there are stocks that are losers, and there are stocks that are more or less flat. In a year when we underperformed the indexes it might be easy to assume that our underperformance was a result of my mistakes. However, for 2019 that was not the case. In fact, netting our 5 largest detractors from our 5 largest winners in 2019 reveals performance that was inline with our performance in our best historical years.

The portion of our portfolio this year – and last year for that matter – that has been most out of step vs. our own history and the market is the middle portion between our top 5 and bottom 5 contributors. ~30% of our invested portfolio was comprised of stocks that finished the year almost right where they started, and an additional portion only moved a small amount.

Importantly, I am not talking about *businesses* that went nowhere. I am talking about *stocks* that went nowhere. The distinction is essential because if the businesses failed to show any improvement, I would perhaps conclude that the theses underlying the investments were broken or wrong, attempt to learn from the experience, and move on.

However, when the businesses themselves are improving but the stock price is languishing, it is difficult to draw any lessons from the experience. For example, consider the following metrics that are attached to a business that spent much of the year as one of our top five investments:

Income Statement	FY'18	An. MRQ	Balance Sheet	YE'18	MRQ	Other	YE'18	MRQ
Gross Profit	$118.7	$126.3	Net Debt	$25.9	$21.9	Backlog	$740.0	$822.0
% change		*6.4%*	*% change*		*-15.4%*	*% change*		*11.1%*
adj. EBITDA	-$1.5	$21.1	Imp. Debt/EBITDA	-16.8x	1.0x	Insider Buys (#)	11	18
% change		∞	*% change*		∞			

To be fair this is not the best business in the world, and it can be lumpy so annualizing the most recent quarter is not entirely appropriate, but zooming out, the business is boring, disruption proof, and executing very well across their income statement, balance sheet, and future potential. And yet, shares returned ~2% on the year, and thus acted as a significant drag on our portfolio vs. the indexes. This is but one example.

The traditional response in situations such as these is simple: **patience**. As super investor Joel Greenblatt has said, "if you do good valuation work, the market will reward you. But I cannot tell you when." This uncertainty around timing means that despite being simple, patience is not easy, especially in a year where the indexes were a reminder that opportunity cost is real.

It is possible that more patience is required today than ever before. Our portfolio is largely comprised of businesses that exist off the beaten track, and whose trailing financials do not tell the whole story. At a time when JP Morgan estimates that 90% of market activity is tied to ETFs and quants, much of our portfolio is thus simply irrelevant or invisible to the dominant forces that are driving the market day to day and week to week. This helps explain why our stocks are cheap at our time of purchase, but also helps explain why they can remain cheap despite legitimate fundamental improvements.

It should also be noted that many of our purchases are based on the idea of expectations-based investing, which seeks to take advantage of human beings' tendency to over-extrapolate the long-term impact of

near-term negative expectations.[i] Value in the stock market exists on a spectrum from balance sheet value, to earnings power value, to under-appreciated growth value, but traditionally the closer one is to the balance sheet and earnings power side of the spectrum, the more overly pessimistic expectations can be exploited, whereas the closer one is to the growth side of the spectrum, the more optimistic expectations must be exceeded. However, in today's market there appear to be legitimate structural reasons for the degradation of expectations-based investing.

In a market that is driven purely by fundamentals, positive expectations lead to higher stock prices until they reach the point where they are overpriced and investors sell them, and negative expectations lead to lower stock prices until they reach the point where they are underpriced and investors buy them. However, in a market that is driven by indexes and quants who may not care at all about fundamentals, this dynamic breaks down. Indexes are market cap weighted, meaning that all else equal they buy more of what is expensive and less of what is cheap. Quants are more varied in their strategies, but recent commentary from the most successful quant of all, Jim Simons at Renaissance Technologies, is illustrative. Simons has said that he does not care at all what something is worth, only how it moves in relation to history and other variables. Simons has further commented that the best predictor of near-term returns is momentum, which all else equal suggests buying what is more expensive rather than cheap.

It is difficult to reconcile the behavior of these market participants with our strategy, which is rooted in common sense. I can think of no reason why our core strategy of simply partnering with good businesses led by incentivized people during times of transitory pessimism will not ultimately end well. At the same time, it is not difficult at all to think of reasons why buying irrespective of value will ultimately end poorly. Yet, the existence and influence of these forces is undeniable, and thus simply waiting for these dynamics to reverse and stubbornly refusing to update one's investing paradigm seems like a strategy that would not properly address opportunity cost. We must be cognizant of the conditions around us.

Regardless of these dynamics, one thing is clear; it is essential that we do not stray from our fundamental beliefs. As such, I have no intention of making broad changes to our process in an attempt to jump on the bandwagon of what is currently "working." I am keenly aware that while low interest rates can justify a higher purchase multiple, success may then be tied to interest rates remaining low, which no one can guarantee.[ii] Further, it is not lost on me that "value" has been underperforming for a long time, and the pendulum can swing back at any time. I have every intention to be there when it does.

What this means in practice is that the hurdle for inclusion in our portfolio for businesses that appear cheap based on the asset side of the spectrum or the middle of the spectrum must be raised. **It does not mean that the hurdle for inclusion for businesses on the growth potential side of the value spectrum will be lowered**. As always, I believe our long-term interests are best served by maintaining a more defensive and conservative stance. We are running a marathon, not a sprint. The net effect on our portfolio however is likely to be a tilt away from just boring and cheap and toward companies that may appear less cheap, yet may be more interesting.

Buffett, Greenblatt, and other legendary investors have noted that they evolved over time to appreciate quality as much as a low price. The market dynamics described above can perhaps best be thought of as an accelerant to my own evolution toward owning higher quality businesses. Rest assured however, a low purchase price and a conservative view of the future will still be an essential requirement.

Top Six Investments

It has traditionally been my practice to list our top five investments, but depending on which way the wind blows our top five has recently been rotating among the following six businesses, presented alphabetically:

Aimia Inc. (AIM.TO / GAPFF) – Aimia was introduced as a pile of cash and varied assets in the Loyalty space in Q3'18 and became a top 5 position in early 2019. Our investment was based on the value of these assets, as well as the belief that an underperforming and improperly incentivized board of directors would be replaced in the near future. While in my estimation the incumbent board destroyed considerable value on their way out, in November it was announced that a new board will indeed be taking the helm in March, and there is much value to be realized from the remaining assets.

As of now, it is not exactly clear what the new board will do upon taking control of the company, which is likely why shares ended the year flat. However, what is clear in my opinion is that a previous bid by Aeromexico for Aimia's ~50% stake in Club Premier ("PLM"), Aeromexico's loyalty rewards business, is better viewed as a completely logical attempt to take advantage of an incompetent board of directors than as a signpost for what the value of PLM actually is. This is a unique, recession resistant asset, that in some ways is key to the future of Aeromexico, who recently noted that competitors are aggressively expanding capacity, making loyalty more important than ever. While in theory it would be possible for Aeromexico to attempt to recreate this asset from scratch, in practice this would make little sense as ultimately it is the banks and credit cards that would pay the bill for an acquisition. It should also be noted that Air Canada's attempts to integrate Aeroplan - their existing loyalty program, which they purchased from Aimia last year - has led to significant operational problems, so one can only assume that building from scratch would be even more challenging. Regardless, for the time being Aimia needs PLM to avoid being designated as a passive foreign investment company (PFIC) so a sale is unlikely to be imminent, the existing contract with Aeromexico runs through 2030, and I believe there are other more creative ways to realize value from PLM then simply selling the asset.

Beyond PLM, the company maintains a sizeable cash hoard which is now in the hands of investors with excellent long term track records, and I think it is safe to assume that corporate level expenses will be cut to the bone, setting the stage to effectively deploy cash in a way that will build value going forward. I do not believe this cash will be deployed into the portfolio of the company's largest shareholders, Mittleman Brothers, as some investors seem to fear, and as the new board communicates their strategy to the markets, I would expect shares to begin to re-rate higher.

Avid Bioservices (CDMO) – Avid is our large molecule Contract Drug Manufacturing Organization (CDMO). Following a year of strong performance marked by increased revenue and early signs of significant operating leverage, the thesis remains the same. This is a recession proof business with powerful industry tailwinds, a growing client list, and significant competitive advantages. Quarter to quarter and even year to year shares are likely to remain volatile as the business matures, but zooming out it is not difficult to imagine situations where a few years from now the company's cash flow matches today's revenue level. That might be 3 years from now or it might be 7 years from now, but given Avid's existing pipeline, extremely high switching costs, and impossible to duplicate regulatory track record, this outcome appears likely. Regardless of the timing, those cash flows will deserve a high multiple, and as the market begins to

value CDMO on cash flow rather than revenue I believe that our IRR on the investment will be somewhere between very good and great.

Hill International (HIL) – Hill, our asset light construction management firm, is the company whose operational improvement I detailed earlier in this letter. Despite a frustrating year where HIL stock went nowhere, I believe our patience will be rewarded shortly. First, on the most recent conference call management went out of their way to note that recent improvements in backlog had not yet translated to increased revenue and that Q4 was off to a good start, which seems to telegraph that when the company next reports earnings, they will be good. To be clear, ordinarily quarterly earnings reports are of limited value to our longer-term theses, but in the case of HIL, moving past next quarter earnings without a major blow up will place the company firmly in the cross hairs of the Russell 2000 rebalance. Being added back to the index has a different dynamic than being removed from the index, but when HIL was removed from the index it led to a ~30% decline in prices. Given that being added to the index means forced buying without regard to price, and given that operationally the business is performing very well means there are unlikely to be many sellers, shares could re-rate considerably higher in the not too distant future. This structural backdrop is notable because in the past, several members of the board of directors have called for a sale of the business, and a higher stock price makes achieving a higher private market value that much more attainable. Even if a sale does not come to pass, the company's improved balance sheet and operating structure will begin to open up options for the board to further improve the company going forward, which should help close the considerable valuation gap with peers.

Iteris (ITI) – Iteris, our Intelligent Transportation business, should be familiar. The company continues its quest to leverage its dominant position (~50% market share) in Traffic Sensors and strong position in Traffic Systems into more software and service centric offerings, and is making significant progress on that front. The company recently brought on a CFO with a strong operational IT background, and two new board members will be joining shortly. I have long felt that the company should move to become a pure play Intelligent Transportation business by exiting their small Agriculture business, and I am hopeful that a reconstituted board will accelerate the move in this direction, increase the company's focus on ROIC, and announce a strategic re-launch in the not too distant future. The Transportation businesses have a long runway in front of them as the move toward Smart Cities is in its early innings, and should grow top line at low double digits organically, while accelerating growth through bolt on M&A.

Recro Pharma (REPH) – Recro was introduced in our Q1'19 letter as a "good co/bad co" opportunity whereby weakness in the company's drug development business led to a severe decline in the stock price, and thus an opportunity to buy the company's small molecule CDMO business at a very low price. In Q4 the company announced they would be spinning off the drug development business creating a pure play CDMO, which unlocked significant value. More exciting however is that the CDMO business has exceeded expectations in terms of growth and profitability, and is set to continue to do so. The presence of an activist investor, the recent move to pure play status, and a very active M&A market suggest that a sale of this business may be in the works in the not too distant future, which should demand a significant premium from today's prices. However, this is a recession proof business with attractive growth characteristics, the company remains cheap on a cash flow basis, and there are opportunities to drive value by improving the capital structure, meaning a sale is not necessary for continued success.

Par Technology (PAR) – Par is a relative newcomer to our portfolio, and joined as a midsized position earlier this year following a convertible bond offering that fortified the company's balance sheet, and

created an opportunity to purchase shares at a discount. I was previously aware of the company due to the actions of friends of LWC, Voss Capital and ADW Capital, who were instrumental in recruiting new CEO Savneet Singh, who has been applying his software experience to remake and reimagine what this family-controlled business could be. There are more than a few moving parts that contribute to the value of PAR, but the bulk of the value is in the company's cloud-based restaurant point of sale system known as Brink. Singh is leading company efforts to increase the doors that Brink is in, while also increasing average revenue per user (ARPU) by adding additional functionality and services to the core Brink offering. At current prices shares may not appear cheap, but there are levers for management to pull that will simplify the story, and the runway remains long, with the company suggesting that several years from now ARPUs could be 4-5x higher than today, and the number of doors that Brink is in could grow several times over. As always, my initial response to company claims regarding the future is skepticism, but my diligence reveals some intangibles which suggest realizing future potential may not be as difficult as a casual observer would expect. Importantly, PAR's current target customer base is made up of quick serve and fast casual restaurants which tend to be recession resistant as consumers still need to eat, and even trade down during challenging economic times.

New Positions

I have begun to purchase shares in three new opportunities that can best be summarized as having terrific long-term prospects, but uncertain or even challenging near term prospects. Note that the value I see in each of these businesses is tied as much to their future potential as their price, which is a departure from some recent investments where quality was sacrificed in pursuit of quantitatively lower purchase prices. For now, I will refrain from naming these businesses as I am actively rooting against the share prices, hoping to take advantage of any additional weakness which they may encounter in the near term.

A fourth new investment which entered our portfolio as a small position before appreciating into a mid-sized position is Clear Media (100:HK). I prepared a slide deck detailing the thesis for the recent Manual of Ideas Best Ideas conference, which you will find under separate cover. In brief, Clear Media has a dominant position in Chinese bus shelter advertising. This is not a sexy business, but with competitive advantages tied to their 70% market share in major cities and contracts that typically run for 10 years, Clear Media is well positioned to benefit from secular tailwinds for decades to come as Chinese consumers mature. At the moment margins are depressed due to broad weakness in the Chinese economy and the American trade war. Simply returning to "normal" levels would result in a doubling of the share price from our purchase, and the fact that Beijing is hosting the 2022 Olympics – which has traditionally been a boon to ad spending – suggests that normal and beyond should not be that far off.

Short Positions

We remain short high yield credit ETFs, while noting that with rates at record lows, spreads at record tights, and defaults at record lows, downside appears limited, while upside could be substantial if (when) the economy weakens and if (when?) the machinations of the ETF structure implode under unforeseen liquidity demands. This compares favorably to an approach that shorts equity indexes where the market could continue to rip higher resulting in a painful short.

Addition of New Partners

Our partnership continues to grow, with notable new additions including entrepreneurs and mutual fund managers. Regardless of their background, these partners are a perfect fit for us as they firmly recognize that successful investing is based on patiently recognizing that stock market price is different than business value. If you are aware of like-minded individuals who are comfortable stepping away from the crowds in pursuit of differentiated investment results, please refer them to the "letters" section of www.laughingwatercapital.com

K-1s and Upcoming Events

I have been in touch with Spicer Jeffries regarding our 2019 audit and tax preparation. I anticipate that K-1s will be available for limited partners by March. If you have any questions, please let me know.

I hope to once again travel to Omaha in May for the Berkshire Hathaway meeting. If you plan on attending and would like to meet, please let me know.

Details have not been finalized, but I anticipate hosting a Laughing Water Capital partner's meeting in Manhattan in September or October. I will provide more details in future letters.

Looking Forward

As always, I have no idea what the market will do in the near term, and believe that anyone who claims otherwise should be regarded with suspicion. When looking at the SP500, more bearish commentators point to record high operating margins, stretched valuations, and an unsustainable reliance on large cap tech as reasons to be cautious on the broad market, and expect middling returns from the indexes going forward. More bullish commentators will note that margins are higher than history because of the impact of asset light tech companies that deserve higher valuations, the tendency of momentum to continue pushing shares higher in the near term, and an accommodative Fed.

I have no idea which side will be right, although I suspect both sides will find a way to claim success depending on the timing.

What I do know is that history has shown that buying good businesses led by incentivized people during times of temporary difficulty or uncertainty is a recipe for long term success. Overtime, buying into an uncertain period will allow us to benefit from the dual forces of operational improvement and multiple expansion, leading to acceptable returns. In my view, owning businesses that still have the ability to improve their operations and still have the ability to enjoy higher multiples is especially attractive at a time when the indexes appear stretched on both fronts. It should also be noted that our portfolio is tilted toward "value" when value is out of favor, and our portfolio is tilted toward small and microcap, when small and microcap are out of favor. The pendulum always swings too far, and at some point, these forces will be tailwinds, not headwinds.

To be clear, it is entirely possible that macro shocks or other unexpected events can bring down both our portfolio and the wider market, but I am more positive than usual about the businesses we own, and I am more positive than usual about how out of favor our strategy is. The temporary forces that drive the market day to day and week to week have been a headwind of late, but ultimately improving fundamentals will rule the day, and in that regard, we appear to be very well positioned.

Please let me know if you have any questions,

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[i] The idea of Expectations-Investing is perhaps best encapsulated by Charlie Munger's observation that the stock market is a pari-mutuel system, akin to horse racing. The potential payout is adjusted based on the odds that a specific horse will win. This idea is greatly expanded upon in the book "Expectations Investing: Reading Stock Prices For Better Returns," by Alfred Rappaport and Michael J. Mauboussin.

[ii] It is also worth noting that paying a high P/E multiple when corporate tax rates are low may lead to disappointment if (when?) corporate tax rates rise, but it seems unlikely that momentum crazed short term investors account for this potential claim on future earnings.

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