Q1
2019

TITAN

Your quarterly letter.

“The greatest shortcoming of the human race is our inability to understand the exponential function.”

ALBERT ALLEN BARTLETT

PROFESSOR OF PHYSICS

The Titan composite* had a strong start to the year, up +18.2% compared to the S&P 500 up +13.6%. It was a sharp rebound from the rapid bear market we entered late last year. Many investors seemed to behave as if the coast were clear. Stock market "FOMO" creeped in. Despite the market's strongest start to a year since 1998, we are still cautiously optimistic.

Market update: Macro concerns persist, but Titan is weathering the storm

On the one hand, your twenty portfolio companies delivered generally robust earnings growth supported by their resilient economic moats. This growth exceeded the "low bar" of expectations set by Wall Street analysts. It's a benchmark we don't pay much attention to because it's irrelevant in the long term. However, the market cares a great deal about "beating earnings" in the short term. That scoreboard looked good for Titan in Q1.

On the other hand, we don't think the macro concerns that caused the sharp correction in Q4 have disappeared. The U.S./China trade war isn't resolved. The Fed's slowing of interest rate hikes is not permanent. Global economic growth (especially in China) continues to slow. These concerns may have taken a back seat in Q1, but they could take back the driver's wheel just as quickly.

Company update: IRAs coming this summer

We'll be launching IRAs this summer (finally!), including Traditional, Roth, and Rollover IRAs. We know many of you have been waiting patiently.

Our objective is to compound your capital at an attractive rate over the long term, and tax efficiency is one of the keys to strong compounding. IRAs are a highly tax-efficient retirement account type, and we're excited to offer these soon. Stay tuned.

Portfolio update: Broad-based strength, with a few big winners/losers

The Titan composite gained +18.2%, with almost half of the 20 companies gaining more than 20% each. 17 out of the 20 companies saw their stocks gain more than the S&P 500's +13.6% rise. Every stock in the Titan composite was up; the worst performing stock, Charles Schwab (SCHW), rose +3%. See full disclaimers at the end regarding performance figures.

When we try to dissect what drove stocks at a fundamental level (beyond macro headlines and investor FOMO), we see that it actually wasn't that anything changed in the fundamentals. It was that investors' beliefs that the fundamentals had broken down just proved to not be true once more data became available.

In a nutshell, we noticed a fundamental flaw in human forecasts called "linear thinking." Which brings us to our thought of the quarter.

*The Titan composite and all other stated performance results represent a hypothetical client with an "Aggressive" risk profile which includes the use of a personalized hedge. Clients with "Moderate" or "Conservative" risk profiles would have experienced lower returns.

Thought of the Quarter: Linear Thinking in a Nonlinear World

Linear thinking is a shortcut for completely thinking through a problem. It's easier to look at the quarterly earnings of $0.25 and multiply by 4 rather than estimate what they might actually be due to seasonal fluctuations and non-recurring events.

This is a huge problem in investing. **Most investors like linear trends because they make them feel like they can guess the future. That's incredibly dangerous.**

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." - Mark Twain

Let's explore linear thinking with a quick example. We'll show you how it has played out in Titan companies recently, and how we can use nonlinear thinking to improve our investing.

Swap Out the SUVs, Not the Sedans

Ready for a brain teaser? Suppose you're responsible for your company's car fleet. Your fleet is split into two models: an **SUV** that gets 10 miles per gallon, and a **sedan** that gets 20. Both travel 10,000 miles per year. You can replace one model with more-fuel-efficient vehicles to lower your costs. Which upgrade is better?

A. Replacing the 10 MPG vehicles with 20 MPG vehicles
B. Replacing the 20 MPG vehicles with 50 MPG vehicles

Intuitively, option B seems more impressive: an increase of 30 MPG crushes a 10 MPG one. The percentage boost is better too (150% vs. 100%). But B is actually the worse option.

Gallons used per 10,000 miles

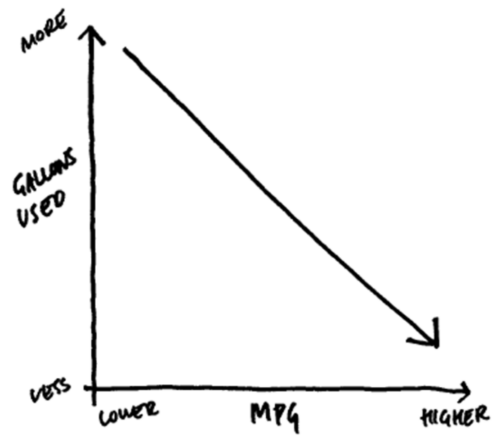
	CURRENT	AFTER UPGRADE	SAVINGS
A. SUV	1,000 (@ 10 MPG)	500 (@ 20 MPG)	**500**
B. SEDAN	500 (@ 20 MPG)	200 (@ 50 MPG)	300

Option A saves you way more gallons. This is surprising to many of us because, in our minds, the relationship between MPG and fuel consumption is simpler than it really is. We tend to think it's linear, but it's actually non-linear.

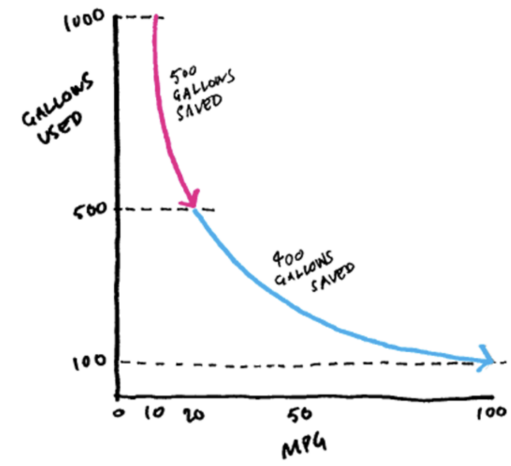
It is much more effective to replace the 10 MPG SUVs with 20 MPG sedans than, say, swapping the sedans for a hybrid electric vehicle.

Source: Harvard Business Review

Linear Thinking



Nonlinear Thinking

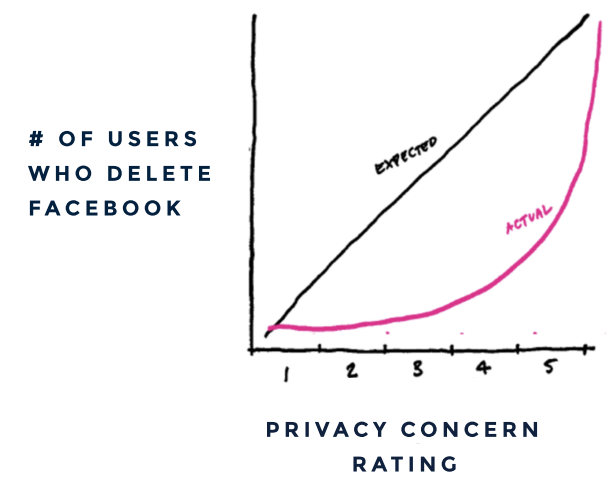


Shockingly, upgrading fuel efficiency from 20 to 100 MPG still wouldn't save as much gas as upgrading from 10 to 20 MPG. Crazy right?

The human mind struggles to understand nonlinear relationships. Our brain wants to make simple straight lines. But in business and especially in investing, there are many highly nonlinear relationships, and we need to recognize when they're in play.

Nonlinearity in Tech Stocks

Data privacy concerns have grown over time at companies like Facebook and Google. They weighed on FB, GOOG, and other tech stocks in 2018. But has consumer behavior changed linearly?



No. Data suggests that only people who say they are extremely concerned about privacy have taken significant steps to protect it (e.g. deleting Facebook).

Most others, regardless of their concern rating, have not adjusted their behavior. You can see it in Facebook's Q4 stats: user growth and engagement both remained strong.

The relationship between what consumers say and do is highly nonlinear. When the market reacts as if it's linear (like in '18), it can be a good investing opportunity.

How to Invest Better with Nonlinear Thinking

Humans are terrible at forecasting based on curves, but we don't need to make a perfect forecast to be great investors. We'd rather be "roughly right" than "precisely wrong."

Our best advice is to avoid making generalizations about a company or stock. Try to understand cause and effect relationships for the stocks you own, then act accordingly.

If a company raises its prices and the stock falls, don't just run for the hills, Ask yourself: how many customers could the company afford to lose and still maintain profits? If the answer is "a lot," the stock could be a good long-term buy. You're thinking nonlinearly.

Source: Harvard Business Review

Trading Activity: New positions in NFLX and DIS; sold FAST and MCO

In our quarterly rebalance in mid-February, we had two new entrants into the Titan composite: Netflix (NFLX) and Disney (DIS). Many hedge funds added and/or sized up these positions in their portfolios in Q1. These replaced Fastenal (FAST) and Moody's Corp (MCO), which were up +20% and +21% from the start of the year through the rebalance date.

Netflix needs no introduction. It's building a significant and defensible advantage in the large and growing streaming video market, with 140 million subscribers globally, each paying an average of $11/month in the U.S. (~$9 internationally). We believe this is very low for the amount of value being delivered to the typical consumer, giving Netflix significant untapped pricing power. We also believe its content investments will help Netflix build a powerful platform that will increasingly eat into the market of traditional Hollywood studios and, over the long term, any market that competes for user attention.

There's a powerful flywheel at work here: the more Netflix invests in content, the more subscribers (and pricing power) it'll gain, the more it can invest in content, and so forth. As the company once tweeted back in 2017: "Sleep is [our] greatest enemy."

Disney is a media company that makes money by monetizing world-class entertainment franchises through movies, TV, theme parks, toys, apparel, and a lot more. For consumers, its media properties (such as the Marvel universe and Star Wars) are legendary and difficult to substitute. These factors give Disney strong pricing power which we think is underappreciated by many investors. Also, Disney will go "all-in" on a subscription video service, Disney+, in late 2019. We believe this streaming platform will create a more sustained Disney experience for consumers, while better enabling the company to better measure and monetize its world-class media library.

NFLX and DIS have solidified Titan's thematic exposure of being "long content." These are the two greatest content & media distribution franchises in the world, in our view. While they both compete for consumers' leisure time, we believe they can coexist.

Active Positions Update: TDG, AABA biggest gainers; SCHW, STZ detractors

Your biggest gainers this past quarter were TransDigm and Altaba, which saw their stock prices rise by 34% and 28%, respectively.

Aerospace supplier TransDigm easily hit its quarterly targets when it reported results in early February. The company continues to raise prices without much customer churn, resulting in powerful profit growth. Pricing power is the core tenet of our thesis for TDG.

We expect the business to grow free cash flow by ~20% per year for the next few years. Compared to the average S&P 500 company expected to grow earnings by less than 10%, we continue to believe TDG is an attractively priced compounding machine.

Altaba, or "alternative Alibaba," rose ~28% in the quarter after what was a very disappointing 2018 in our view. Altaba owns a hodgepodge of shares and cash, but mostly Alibaba stock, so its share price tends to track Alibaba's. Alibaba rose more than 30% in Q1, and Altaba followed.

The stock fell more than 20% last year after management's conversations with Alibaba (who it hoped would acquire Altaba in a tax-efficient deal, resulting in a higher share price for Altaba) fell short. While Q1 was a nice rebound, Altaba waved the proverbial white flag in early April when its board voted to liquidate the entire company and return the proceeds to shareholders.

Your biggest detractors (or, we should say, smallest gainers) this past quarter were Schwab (SCHW) and Constellation Brands (STZ), up +3% and +9% respectively.

We believe Schwab's share price lagged the market in Q1 due to the Fed's slowing of interest rate hikes. Schwab is an investment brokerage firm that generates a lot of its revenue from net interest income (e.g. it invests the spare cash in your Schwab account and keeps the interest as income). Net interest income is tied to the level of interest rates: lower interest rates means lower interest income for Schwab in the near term. Hence the stock price lagged vs. others.

Constellation Brands lagged the broader consumer sector and the overall market in Q1 as many investors appear to be waiting to see how its recent Canopy Growth cannabis acquisition plays out. The deal, which STZ struck in 2018, was done using a lot of debt, and the interest cost of that debt will weigh on STZ's earnings in the near term. However, management believes cannabis could be a $1B+ sales opportunity (in Canadian dollars) soon, justifying the costs.

Even if you eliminate the cannabis opportunity, the core Corona + Modelo beer business is large enough to us to make STZ an attractive long-term investment, especially at today's levels, in our opinion.

Final thoughts

As Q1's results showed, the market can be highly unpredictable and move violently to the upside and downside in the short term. Don't cheer if the market rips upward, and don't fret during excessive volatility.

If you're investing for the long term – and we hope you are– rather than trying to guess which stocks are going to be popular tomorrow or next week, park your capital in businesses you believe will be alive and resilient in ten years. We think it's the Titan composite.

"In the short term, the market is a popularity contest. In the long term, the market is a weighing machine." - Warren Buffett

	TITAN	S&P 500
2019 First Quarter Performance	+18.2%	+13.6%
2018 Full Year Performance	-7.0%	-6.1%
All-Time IRR	+9.0%	+6.0%

All performance results are net of fees and include dividends and other adjustments. Figures represent a hypothetical portfolio for a client with an Aggressive risk profile; Conservative and Moderate clients would have experienced lower returns. Note: 2018 Full Year results are from Titan's launch date of 2/20/18 through 12/31/18. 2019 First Quarter results are from 1/1/19 through 3/31/19. All-Time IRR represents the internal rate of return from Titan's launch date of 2/20/18 through 3/31/19. See full disclosures that follow.

LONG

You are always long 20 stocks, updated automatically on a quarterly basis. These are, what we believe to be, world-class businesses which can hopefully deliver superior returns.

Constellation Brands	Strongest diversified beverage portfolio	**Boeing**	The world's leading aircraft maker in a stable duopoly
TransDigm	Dominant niche aerospace parts supplier	**Mastercard**	Duopolistic industry structure with Visa
Facebook	Poised to capture shift in advertising dollars online	**Charles Schwab**	Leading Investment brokerage with flywheel effect
Broadcom	World-class semiconductor manufacturer	**Altaba**	Owns major stake in Alibaba
Microsoft	Shift from legacy PC business to cloud-based services	**PayPal**	Positioned to benefit from eCommerce growth
Amazon.com	Growing dominance in online retail	**Charter Communications**	Broadband service provider
Alphabet (Google)	Owns Google and has several monopolies	**Netflix**	Global streaming video giant with untapped pricing power
Apple	Consumer and technology leadership with loyal base	**Salesforce.com**	Market leader in growing CRM software
Credit Acceptance Corp.	Leading subprime auto lender with unique loan program	**PTC Inc.**	Industrial software platform shifting to subscription model
Visa	Growing transition to electronic payments	**Disney**	Entertainment franchise machine shifting to subscription business model

SHORT

You are automatically short the market using an inverse S&P 500 ETF. This means when the broader market declines, you have the opportunity to make money. It's a way, we believe, to reduce the overall risk of your portfolio. The size of the short is personalized based on your individual risk tolerance.

TITAN

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Performance results are net of fees and include dividends and other earnings. 2019 First Quarter results are from 1/1/19 through 3/31/19. 2018 Full Year results are from Titan's launch date of 2/20/18 through 12/31/18. All-Time IRR is from Titan's launch date of 2/20/18 through 3/31/19. All-Time, 2018, and 2019 First Quarter figures represent performance of a hypothetical account created on Titan's launch date of 2/20/18 using Titan's investment process for an aggressive portfolio, not an actual account. All-Time IRR is calculated using Microsoft Excel's XIRR function based on an illustrative starting Titan account value of $1,000 at inception on Titan's launch date of 2/20/18 and its ending value on 3/31/19. Results for the Titan portfolio as compared to the performance of the Standard & Poor's 500 Index (the "S&P 500") is for informational purposes only. Account holdings are for illustrative purposes only and are not investment recommendations. The S&P 500 is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The investment program does not mirror this index and the volatility may be materially different than the volatility of the S&P 500. Reference or comparison to an index does not imply that the portfolio will be constructed in the same way as the index or achieve returns, volatility, or other results similar to the index. Indices are unmanaged, include the reinvestment of dividends and do not reflect transaction costs.

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