Q2
2019

TITAN

Your quarterly letter.

“Give me six hours to chop down a tree and I will spend the first four sharpening my axe.”

ANONYMOUS WOODSMAN

EXEC SUM **The Titan composite* rose +4.5% in Q2, compared to the S&P 500 up +4.3%. It was a more moderate gain following Q1's sharp rally, but U.S. stocks still finished with the best first half since 1997. Headlines were busy, but the primary focus remained on China and the Federal Reserve. At Titan, Disney and Facebook led the pack, up 26% and 16%, respectively.**

Market update: Shrugging off concerns about a "tech cold war"

The U.S. and China continue to negotiate trade relations. This trade story swerved from the sense that a deal was near in April, to an abrupt breakdown of talks in May, back to restart talks in late June. The narrative was further complicated by the U.S. decision to place restrictions on China's Huawei, raising concerns about a "tech cold war."

This geopolitical whiplash dominanted the market's trajectory in Q2. The S&P rose 4% in April, fell 6% in May, and rose 7% in June. The prospects for a possible slowdown in the U.S. economy were also debated amid some mixed data reports and Q1 earnings season results (which showed a year-over-year decline for the first time since 2016).

Still the market was still able to largely shrug off these geopolitical tensions and economic growth concerns, with the S&P 500 finishing the quarter up +4.3%.

Portfolio update: A volatile surface, with steady compounding underneath

The Titan composite gained +4.5%, with a broad complexion of gainers and losers across industries. See full disclaimers at the end regarding performance figures. We found that, in contrast to Q1's broad-based strength, Titan's performance in Q2 was much more idiosyncratic at the single-stock level. In other words, it was very company-specific.

For example, Disney was the biggest gainer in Q2 (+26%) after the market reacted positively to early details about its upcoming Disney+ streaming video launch. Alphabet (GOOG) was the biggest laggard (-8%) after it fell sharply on a Q1 advertising revenue shortfall.

With such wide dispersion in stock returns in a single quarter, we think it's helpful to zoom out and reflect on what actually drives those returns over the longer term in this quarter's "thought of the quarter."

Company update: IRAs coming later this summer

We'll be launching IRAs later this summer (finally!), including Traditional, Roth, and Rollover IRAs. We know many of you have been waiting patiently. IRAs are a highly tax-efficient retirement account type, and we're excited to offer these soon.

We brought on two new Titans: Jason (formerly Head of Growth at TheSkimm) and Chris (formerly an engineer at Bloomberg). They're already helping make Titan better for you.

*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: The Math Behind Compounding

At Titan, our aim is to invest your capital in a concentrated portfolio of high quality, predictable businesses that can be expected to grow intrinsic value at high rates.

By following this long-term oriented strategy, our investment returns come from two possible sources:

1. The internal results of each business (operating results)
2. The market's "revaluation" of the business ("multiple expansion" in Wall Street jargon)

As we'll show below, #1 is much more important than #2 in the long run. #1 means that business quality (which we measure by "return on invested capital", or ROIC) will drive most of a stock's long-term returns – much more than the market's valuation of the stock.

Like a Sharpened Axe, ROIC is a Strength Multiplier

If you hold a stock for 10 years, your ultimate compounded return will be driven **almost entirely** by the quality of the business (ROIC), not Wall Street's valuation. It's a strength multiplier that makes the price you pay for a stock (e.g., P/E ratio) matter much less over time.

The sharper the ax, the less strong you need to be to chop down the tree.

To understand why, let's look at a hypothetical example of two businesses: Vintage Tees (a t-shirt shop) and FitNews (a subscription fitness blog).

Vintage Tees produces 10% ROIC and can reinvest 100% of its earnings
FitNews produces 20% ROIC and can reinvest 100% of its earnings

Assume you owned both stocks for 10 years. We'll show how both the valuation (e.g., P/E ratios) and business quality (e.g., ROIC) impact our investment returns over 10 years.

	STOCK PRICE	EARNINGS PER SHARE	VALUATION (P/E RATIO)	ROIC
VINTAGE TEES	$10.00	$1.00	10x	10%
FITNEWS	$20.00	$1.00	20x	20%

Which stock do you think would perform better over the 10 year period? Even though Vintage Tees has only a 10% ROIC, it is much cheaper today at 10x P/E ratio. FitNews is 2x more expensive. Shouldn't you look for "cheap" stocks?

	Vintage Tees			FitNews		
	Today	Year 10	Annual Growth	Today	Year 10	Annual Growth
Earnings	$1.00	$2.59	10%	$1.00	$6.19	20%
P/E Ratio	10x	10x		20x	20x	
Stock Price	$10.00	$25.94	**10%**	$20.00	$123.83	**20%**

Assuming the valuations stayed the same, paying 20x P/E for FitNews stock today would outperform the "cheaper" Vintage Tees stock. FitNews is a better business that can grow at 20%. It has a sharper axe.

"Wait. But what if FitNews, a tech company, experienced a major correction in its valuation? It's at a high valuation today. There could be another crash in tech stock prices."

OK, suppose the software industry was in a bubble that bursted in Year 10. FitNews's valuation gets cut in half, from 20x P/E to 10x P/E. Does the sharp axe still win? Even in this dark sky scenario, the answer is yes.

	Vintage Tees			FitNews		
	P/E Ratio	Stock	Annual Return	P/E Ratio	Stock	Annual Return
Status Quo	10x	$25.94	10%	20x	$123.83	20%
Correction	10x	$25.94	10%	15x	$92.88	17%
Bubble Burst	10x	$25.94	10%	10x	$61.92	12%

Even if FitNews' valuation collapsed in half, from 20x to 10x in 10 years, you still would have outperformed Vintage Tees. You would have earned a +12% annual return from owning the software stock at 20x P/E today vs. the +10% return from owning a cheaper apparel stock at 10x P/E today.

This is why Buffett always talks about great businesses – the math proves that quality (measured by ROIC) is the #1 driver in determing your long-term return.

"If you're right about the business, you'll make a lot of money." - Warren Buffett, University of Georgia, 2001

Picking the right business – one which can reinvest capital at high rates of return over time (e.g., high ROIC and reinvestment rate) – is far more important than finding the stock with the lowest P/E ratio.

Trading Activity: New positions in IAC and ADSK; sold AABA and AVGO

In our quarterly rebalance in mid-May, we had two new entrants into the Titan composite: InterActiveCorp (IAC) and Autodesk (ADSK). Many hedge funds added and/or sized up these positions in their portfolios in Q2. These replaced Altaba (AABA) and Broadcom (AVGO), which were up +22% and +16% from the start of the year through the rebalance date.

InterActiveCorp, known as "IAC," is a leading media and internet holding company. It owns a portfolio of more than 150 brands and products, including an 80%+ stake in Match Group (which owns Tinder, Hinge, Match.com, etc.) and an 80%+ stake in ANGI HomeServices (which owns Angie's List, HomeAdvisor, Handy, and others).

We see IAC as the "Berkshire Hathaway of digital properties" because it operates a similar business strategy. Its more mature businesses (like Match.com) throw off tons of cash flow that IAC reinvests in younger, faster-growing businesses (like Tinder). Some of those young guns eventually become cash cows themselves, and the virtuous cycle continues. In addition to this virtuous cycle of growth and cash flow, we love the network effects inherent in IAC's properties. For example, Match.com may seem like an outdated site but the sheer number of users and relationships built on the platform makes it hard for users to leave.

We see Autodesk as the Microsoft Excel for designers. The company is a design software leader known for its flagship product AutoCAD, which allows designers to create precise 2D drawings and 3D models. The company is viewed as an indisputable leader in its class and is an indispensable part of its customers' workflows. We think this gives Autodesk incredible pricing power that we believe it still largely untapped.

The company is in the final innings of its transition from a one-time license sales model to a more recurring subscription SaaS (software-as-a-service) model. We believe this transition will give Autodesk greater ability to exert its pricing power and also create more predictability in its revenues, which the market tends to value more favorably.

Active Positions Update: DIS, FB biggest gainers; GOOG, SCHW detractors

Your biggest gainers this past quarter were Disney and Facebook, which saw their stock prices rise by 26% and 16%, respectively.

Entertainment giant Disney surged after announcing details on its upcoming streaming video platform, Disney+. The main focus was on its incredibly compelling price point ($6.99/month) for basically unlimited Disney content (e.g., Pixar, Marvel, Star Wars, etc.).

At half the price of Netflix, we see many families flocking to subscriber for Disney+ when it rolls out in November 2019 – even for the children's content alone. Disney's management is projecting 60-90M global subscribers within five years. That's well behind Netflix's 140M+ subscribers, but it seems like a conservative target given the value proposition.

Facebook rose ~16% in the quarter after it reported record users and earnings in Q1 despite major security investments. “We can do both,” said COO Sheryl Sandberg.

Instagram (owned by Facebook) continues to grow at a rapid clip, even as the core Facebook app's business slows. Beyond Instagram, the company is adapting its advertising model to the relatively new Stories format across its various apps, with strong early signs.

Your biggest detractors this past quarter were Alphabet (GOOG) and Schwab (SCHW), down 8% and 6% respectively.

Alphabet (Google) fell sharply on Q1 results in late April, due primarily to an advertising revenue shortfall. Ad revenue grew “only” 17%, which was the first time Google has grown less than 20% since 1Q 2015. Investors seemed shocked by the slowdown; however, after digging into the numbers, we were much less concerned.

Google is deliberately building its business slowly, bypassing revenue it could be making so it can drive more viewers. We think the Q1 ad sales slowdown was self-inflicted (e.g., due to changes at YouTube's recommendation engine), not a structural problem for GOOG. That said, the "slowing growth" narrative could continue to weigh on the stock in the near term.

We believe Schwab’s share price lagged the market again in Q2 due to the Fed’s slowing of interest rate hikes. Schwab is an investment brokerage firm that generates much of its revenue from net interest income. Lower interest rates mean lower interest income for Schwab in the near term. We wouldn’t be surprised if the stock price continue to lag until interest rates bottom out (e.g., if/when trade tensions ease up, when inflation rises, etc).

Final thoughts

We think volatility is here to stay for the foreseeable future, and that’s okay. Q1 may have lulled investors into a false sense of security (“trade tensions are behind us!”), but Q2 was an abrupt wake-up call of volatility (even though stocks still finished the quarter higher).

With the market so prone to gyrations at even a simple presidential tweet, we wouldn’t be surprised if some exogenous (unpredictable) shock sent stocks into another correction. Stocks are near all-time highs, and macro risks abound. However, the same could have been said several years ago, and moving to cash would have cost you signficant returns since then.

Instead of trying to time the up/down gyrations of P/E valuations (e.g., what Mr. Market is willing to pay for stocks on a given day), we’d rather stomach the volatility and focus more on the Titan composite’s ROIC. We think that’s the path to optimal long-term compounding. On an ROIC basis (~20% average vs. S&P’s ~10%), we feel great about our positioning today.

	TITAN	S&P 500
2019 First Quarter Performance	+18.2%	+13.6%
2019 Second Quarter Performance	+4.5%	+4.3%
2019 Year-to-Date Performance	+23.5%	+18.5%
2018 Full Year Performance	-7.0%	-6.1%
All-Time IRR	**+10.9%**	**+8.2%**

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. 2018 Full Year results are from Titan's launch date of 2/20/18 through 12/31/18. 2019 Year-to-Date results are from 1/1/19 through 6/30/19. All-Time IRR represents the internal rate of return from Titan's launch date of 2/20/18 through 6/30/19. 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
Autodesk	The "Microsoft Excel" for designers	**InterActiveCorp**	The "Berkshire Hathaway of digital properties" like Tinder
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 Second Quarter results are from 4/1/19 through 6/30/19. 2019 First Quarter results are from 1/1/19 through 3/31/19. 2019 Year-to-Date results are from 1/1/19 through 6/30/19. 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 6/30/19. 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 6/30/19. 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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