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# Our Own Link to the Past

2019 Annual Letter | November 2020

> *"Interestingly enough, although I consider myself to be primarily in the quantitative school (and as I write this no one has come back from recess – I may be the only one left in the class), the really sensational ideas I have had over the years have been heavily weighted toward the qualitative side where I have had a "high-probability insight". This is what causes the cash register to really sing."*
>
> \- Warren Buffett

> *"If you are a value investor, you are probably genetically mutated and comfortable being in the minority. This is unnatural to human beings. You have to be comfortable being by yourself. You have to adopt the idea that you are right because of your reason and evidence, not because others agree with you. You will probably spend most of your time being an academic researcher rather than a professional. You are a researcher or journalist, with insatiable curiosity. You are trying to figure out how everything works. The more you know, the better you are as an investor. Occasionally you can find something that will give you tremendous insight that other people don't have."*
>
> \- Li Lu

> *"Investing is a search for truth. It requires you to know who you are. It requires you to see your biases and perceptions as they really are. It requires you to see yourself clearly, before you can see something else clearly. Truth doesn't allow for a big ego and doesn't give a s*** about why you think you're right. If you don't know this going in, the truth is going to kick your ass."*
>
> \- Jim O'Shaugnessy

Dear Partners,

We're pleased to present our annual letter for 2019. It's quite belated – indeed, it also addresses much of 2020 – but we believe it provides helpful insight into our performance to date, and into the Fund as a whole and how we run it. We hope you agree. Of course, we would be happy to discuss our philosophy, our process, and our returns in detail. Simply shoot us an email or give us a ring, as always. That is, after all, what we're here for.

## INTRODUCTION: FINDING WARMTH IN WINTER

In the 1993 comedy Groundhog Day, TV weatherman Phil Connors (played by the inimitable Bill Murray in perhaps his greatest performance) is doomed to relive the same frigid February day over and over and over. Each morning, he wakes up at the start of the day he just lived through, never reaching tomorrow. Stuck in winter seemingly forever, he growls "It's gonna be cold, it's gonna be gray, and it's gonna last for the rest of your life."

However, after repeating that same day multiple times, Phil eventually discovers winter's beauty and warmth. Signing off from his live coverage of the Groundhog Day ceremony in Punxsutawney, Pennsylvania, he states:

> *"When Chekhov saw the long winter, he saw a winter bleak and dark and bereft of hope. Yet we know that winter is just another step in the cycle of life. But standing here among the people of Punxsutawney and basking in the warmth of their hearths and hearts, I couldn't imagine a better fate than a long and lustrous winter."*

For four years and counting, the market has had us feeling like we, too, are reliving the same day over and over ad nauseam, as our small- and micro-cap value niche has been battered by blizzard after blizzard. But, like Phil, we've found warmth in this harsh winter: in 2019, the Fund returned 32.5% net. We've stayed warm throughout 2020, also, with the Fund up 55.8% net through October.

We've also done well over the longer term. from the Fund's inception on June 6th, 2016 through October 2020, we've delivered 156.4% net to our limited partners, for an annualized return net of all fees and expenses of 23.8%. Not only have we exceeded the goal we set for ourselves at inception – a 15% net annualized return – but we've also surpassed our competition on both sides of the active/passive divide.

Although significantly outperforming various benchmarks year after year is satisfying, protecting your capital from downturns gives us far greater joy. On that score, delivering strong performance in one of the toughest environments on record for small- and micro-cap value investing has made us positively ecstatic. Our decline in February and March of this year was less than half that of the market (and roughly one-third that of our benchmarks). Then, from April through October, we exceeded the market's recovery by a considerable margin. Indeed, taking the Fund through a full cycle, with plenty of relative performance tests in both good and bad markets, seems to have validated our practice of value-oriented "offensive defense," which offers risk-averse investors the best of both worlds: the strong promise of beating our benchmarks over multi-year periods, while protecting capital when times get tough.

Our success over the shorter term was a function of investing in deeply undervalued small- and micro-cap special situations, as counterintuitive as it may seem, given how treacherous small- and micro-cap investing has been generally. The key here is "special situations", where we have identified liquidity-driven catalysts that reliably force the unlocking of value in individual companies. Longstanding and familiar themes have also proven their worth: stable, highly resilient businesses undergoing some form of value-unlocking change, for example, and our penchant for investments geared to the ongoing digitization of the ways we all live, work, eat and play come to mind.[1]

In fact, we're happy to report that our favorite secular megatrend shifted into high gear this past March as people around the world increasingly shopped, worked, and entertained at home in response to the pandemic. As a result, consumers and businesses increased their use of, and dependence on, the Internet, and pulled forward years of future demand.[2] Many of our portfolio companies are basically selling digital picks and shovels to companies prospecting in this online gold rush, so naturally they've been doing quite well.

As pleased as we are with our performance in 2019 and thus far in 2020, I would be remiss if I did not state two sobering reminders. First, our short-term results are really of little significance to long-term investors like us, except to the extent that they are part of a much longer track record. What we care about is maximizing long-term compounded returns while protecting capital. Second, we're delighted to have beaten our benchmarks for over four and a half years running, but that's a streak that we're unlikely to repeat. I'm not usually one to prophesy, but in this case, I'll make a rare exception: I guarantee we'll experience periods of (hopefully short-lived!) relative underperformance in the years ahead. We still love our odds of winning the marathon by a considerable margin over the long run, but it's absurd to expect that we'll be leading every step of the way.[3] We're more than fine with that.

Moreover, now is a good time to address the elephant in the room when it comes to any emerging manager: Lucky or Good? The short answer is that I believe we've mostly done well for the right reasons. In other words, our strategy of buying deeply undervalued businesses whose virtues others have yet to discover was far and away the primary determinant of our results. That's not to discount the role of luck in investing, but it is to say that figuring out what something is worth and buying it for less just works, especially if we've identified a catalyst-rich event to accelerate the market's recognition of value.

So, we're not counting on being lucky. We're counting on undervalued investments trading up to fair value over time. That's a strategy, properly executed. It's conservative, it's opportunistic, and it's proven.

That's right, what we're doing is proven. It's been done before. Of course, we have to do it well, but it's not a newfangled gizmo or a revolutionary manifesto. We're not re-inventing the wheel. We're not coding a faster algorithm. We don't have a new and improved dart board, crystal ball, Ouija board, or in-house wizard to help us identify great investments. At least, we don't have better versions of any of these "tools" than anyone else.

(1) Thanks to Lakehouse Capital's Joe Magyer for this excellent formulation.

(2) Dennis Hong of Shawspring Capital estimates that US e-commerce made a decade's worth of market share gains in just 90 days. It's a truly incredible phenomenon.

(3) At the risk of raining on our own parade, our outperformance margin relative to our benchmarks will probably narrow over time. Still, if we can maintain a relative outperformance margin just half as wide what we've delivered to date, and if our benchmarks deliver average annual net returns of 5-7% (a reasonable long-term assumption), we'll do just fine. In that scenario, an investment of $100,000 would compound at ~15-17% net of all fees and expenses, growing to ~$405,000 in 10 years and ~$1.6 million in 20. Thanks to the miracle of compounding, even small margins of outperformance really make a difference over time.

You might justifiably ask, then, "Well, Ryan, what makes Crossroads so special compared to the thousands of other investment options available to me?" It's a great question, because although what we are doing has a long and proven history, we are a radically unconventional firm in today's investment landscape. The explanation is old hat to many of you, but it's one that's worth repeating as we welcome new partners into the partnership. And to answer it with the fullness it deserves, so that you really see where we're coming from, we'll need to go back some 60 or so years to examine the principles and approach that underpinned another radically unconventional investment vehicle founded in the heart of "flyover country."

## THE ORIGINAL BUFFETT LPS: OUR OWN LINK TO THE PAST

Our story begins not in Crossroads' home of Kansas City, but in Omaha, when a young Warren Buffett set out on a path that would change both his and his investors' lives. It's a story that turns on an investment strategy that remains every bit as well-conceived and evergreen in 2020 as it was some 64 years ago. It's also a story that goes to the very heart of our own mission, to who and what Crossroads is and aspires to be. After all, we've modeled our Fund after the investment partnerships managed by Buffett from 1956 to 1969, what we call "Buffett 1.0". It was at this time that he established not just his reputation, but also an investment vehicle that was as unusual at that time as it was successful, and one that delivered his best years of performance relative to the market across his storied six-decade career. In fact, the Buffett LPs not only crushed the market consistently, they never experienced a single down year. The reality is that none of what would eventually happen at Berkshire Hathaway would have been possible without those early LPs that served as the foundation for how the Oracle of Omaha built his wealth. What, then, makes those early Buffett LPs so instructive to investors like Crossroads who seek to create a similar hall-of-fame investment record? Let's dive in and see.

When it came to outperforming the market, Buffett did pretty well (to put it mildly). But the vast majority of his active manager peers did not. In fact, they delivered pretty much the same outcomes in aggregate as they do today – mediocre returns at best, while charging high fees for the privilege. As a result, the ordinary investor seeking diversified exposure to common stocks who did not have the time, inclination, or expertise to do it herself had no other choice (index funds as we know them came on the scene around 1975).

Perhaps unsurprisingly, Buffett saw the structural flaws that compromised the industry-standard operating model from the very beginning. As his early letters attest, he understood that with fees, taxes, over-diversification, and psychology all working against the average active manager, the performance of actively managed trusts and mutual funds would fall far short of the broad market's returns.

But that isn't the only reason Buffett held the traditional fund management industry (and Wall Street more generally) in disdain from almost the very start of his career, when he started as a stockbroker working for his father.4 The issue for Buffett was simple: he didn't like selling stocks because working on commission pitted his personal interests against those of his clients, and in doing so, flipped the role of a true fiduciary on its head. Buffett's criticisms of the investment management industry have been often been labeled hypocritical. In fact, the opposite is true. As his Berkshire partner Charlie Munger would later put it:

*Mutual funds charge two percent per year and then brokers switch people between funds, costing another three to four percentage points. The poor guy in the general public is getting a terrible product from the professionals. I think it's disgusting. It's much better to be part of a system that delivers value to the people who buy the product.*

While we think there are many good people that do their best in this business, we're not going to sugarcoat the issue. The situation is simply appalling. And as Buffett's early letters attest, it's certainly nothing new. In fact, most of the "risk management" and other common standards within the actively managed equity fund industry represent little more than the triumph of marketing slogans over truth. Indeed, we'd argue the contemporary industry is not only dangerous to your financial fortunes, it's largely a thinly veiled wealth transfer mechanism whose secular decline is, candidly, long overdue.

The good news, though, is that more and more ordinary investors are figuring this out. Over the past decade, Main Street has shifted trillions of dollars in AUM from conventional actively managed equity funds to lower-cost passive alternatives run by investment firms like Vanguard. Main Street's very sensible conclusion seems to be that if most active managers can't beat the market, you might as well just join the market – not only will you likely end up with a better outcome, you'll pay a lot less in fees along the way (the one by means of the other). As Jeremy Miller, the author of Warren Buffett's Ground Rules explains, the traditional active management industry now seems headed for oblivion:

*"Today, all active investors, both professional and individual, have to outperform to justify their action. Most don't. Many funds, especially the ones investing in hundreds of stocks at a time (Buffett calls these the Noah's ark school of investing–two of everything), appear to be clinging to a business model whose extinction seems almost inevitable."*

So, while it took decades for the active management industry's chickens to come home to roost, at this point it's clear that the industry as we've known it is in terminal decline. And frankly, we say good riddance. Why? Well, for one we're not going to bemoan the disappearance of the wanton value destruction taking place at ordinary investors' expense under any circumstances. In fact, far from being dismayed by value investing falling out of fashion, or the accelerating disruption taking place across conventionally managed equity funds, we're thrilled. After all, the more active value managers who throw in the towel, the more opportunities there are for us to exploit. We're reminded of how in the movie Forrest Gump, a storm destroyed all the shrimp boats that had been docked in the harbor. Only Forrest rode out the storm and emerged successful, with his competitors eliminated and the entire catch to himself.

(4) Buffett began as a stockbroker. However, because he was encouraged to churn his clients' portfolios, he quickly lost interest in the job. And as the perverse incentives and perpetual value destruction within the industry grew worse over the years, his criticisms of the industry grew louder.

But why do smart, well-staffed, well-resourced, well-connected, experienced investment managers so consistently fail to beat an unmanaged index? And how is it possible for a firm like Crossroads to beat the pants off them when they have a hundred times our resources, better access to company management, and teams of highly credentialed analysts? The truth is that traditional asset managers knowingly act in ways that undermine their own results, and they do this because they have no choice – assuming they want to keep their jobs.

We're not exaggerating. Active mutual fund managers need to make sure that their results each quarter aren't too far below that of whatever benchmark they measure themselves against or their ratings, as issued by companies like Morningstar, are likely to dip, which in turn will cause prospective retail and institutional investors alike to look elsewhere. And they need to do it while sticking to an often narrowly defined segment of the market, lest they find themselves accused of "style drift" by fee-skimming financial intermediaries who are generally glorified salesman essentially playing pretend. Even active hedge fund managers can feel the pressure of big institutional investors heading for the exits after a rough stretch of poor performance. In other words, many active managers sabotage their own results because the business of investing is at odds with the craft of investing. And it's easy to see why. The minute a manager trades owning 246 stocks in the name of "diversification" for a concentrated portfolio of best ideas, volatility will spike. When volatility spikes, investors get nervous. When investors get nervous, they leave. When investors leave, AUM goes down. When AUM goes down, management fee income goes down. See the problem? In short, it's a vicious cycle that would require most funds to actually put their clients' interests above their own. And for that reason alone, will never happen.

At Crossroads, we've decided to take a different route. Following Buffett's example, we built our business from the ground up with a mindset and practices that promote long-term outperformance and the prudent compounding of wealth. Just as engineers strip every ounce of extra weight from a race car, we did away with common portfolio management practices that, however widespread they might be, could only undermine our returns. On a practical level, that means we've avoided the pitfalls common to the industry. We've actively avoided everything from overdiversification to counterproductive policies like "daily liquidity" and monthly letters. So, rather than endorse policies that masquerade as wisdom, we've chosen to hold fast to old school virtues like honesty, integrity, and prudence instead.

It's been a more difficult road, no doubt. And it's one that is guaranteed to be misunderstood often. That's fine by us. Better to hold firm to the conviction that high ideals will ultimately be rewarded, rather than roll around like pigs in the dirt. It's unfortunate, but the vast majority of our peers seem to prefer job security, greater compensation, banker's hours, and a lower handicap on the golf course, over policies and procedures that actually put the clients they claim to serve first. Policies, mind you, that poison the integrity of their investment operations from the bottom up.

In any case, if that all sounds like hyperbole, we're of the opinion that it arguably doesn't go far enough! Let me go through just a few of the reasons underpinning our pessimistic outrage, and what we've done in response.

## Industry Problem #1: Obsessing over short-term results

As we mentioned above, many active managers feel pressure to avoid even brief stretches of short-term underperformance. As a result, they may be too quick to close out positions that have lagged or even gone against them, locking in losses in a bizarre game of window dressing out of fear they'll be judged. And the sad truth is that they're correct. Most professional investment managers are evaluated over periods of 12 months or less.

## Crossroads' solution: Long-term focus

Many of you may have noticed that for the first time I've decided to make an exception to our policy of not reporting our performance against the Russell and other benchmarks. As you know, we've never been big proponents of publishing near-to-intermediate term relative performance data. Not only because performance metrics over periods spanning less than 36 months are objectively meaningless, but because the fund's policy of not reporting short-to-medium term reflects our effort to remove the kinds of influences that cause most actively managed funds to succumb to short-term performance pressures.

Here's another example: we only want partners who are genuinely unconcerned with how our Fund performs in any given year. It's not easy to find investors of this quality; marketing people look at me like I'm nuts. After all, it means less assets to manage and smaller paychecks, yet it's crucial to our efforts to maximize long-term risk-adjusted returns on your behalf. If that means we miss out on some short-term rallies, or risk looking like we're out of step in any given quarter or year, so be it. Charlie Munger said it best: "Someone will always be getting richer faster than you. This is not a tragedy."

Munger's point is a profound one: caring about whether someone is making money faster than us is not just a bad habit, it's also totally nuts! Our partnership is not an index, but a concentrated portfolio of carefully curated investments built one idea at a time as opportunity knocks. This means that the composition of our portfolio, as well as the strategy that creates it, is by design substantially different from our benchmarks. As a result, the Fund's performance will correlate to the combined outcomes of those individual ideas over a period spanning years, rather than how the general market does over an equivalent time period.

Granted, the Fund's performance may be very correlated with the broader market in the near term, but it also may be less correlated in any given month, quarter, or year. That means that significant gyrations in either direction are no reason for us – or for our investors – to celebrate or to despair. Such divergences are par for the course in a Fund like ours over the short run.

The same is true of periodic drawdowns. But again, serious investors focused on fundamental values should rejoice when such periods present themselves. Indeed, the far more consequential issue isn't whether or not a Fund like ours periodically takes its licks (which is inevitable), but how a fund manager and its investors react when it does. As Buffett has said:

> *"There is simply no telling how far stocks can fall in a short period … Even if your positions aren't immediately threatened by the plunging market, your mind may well become rattled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."*

Simply put, an investor focused on long-term wealth creation can't be distracted by short-term issues or concerns. We aren't. Like Buffett, we set out to create an investment vehicle that would maximize our odds of long-term success. That means doing away with asinine conventions that inhibit our ability to think and act clearly while maintaining a healthy psychology, a consistent research process, and a truly long-term view amidst inevitable periods of market upheaval and/or temporary underperformance.

## Industry Problem #2: Following a single approach in a limited investment universe

Many active managers follow a single investment approach, such as buying "growth" stocks. Often, they place further restrictions on this mandate by limiting themselves to stocks of companies in a particular market cap range, a particular industry, or a particular country or region. For example, a fund might invest only in U.S. stocks, in biotech stocks, or in mid-cap stocks – or even in only stocks falling into some combination of those categories. It's frankly all a bit silly if you ask us.

The problem, then, with these types of approaches is that sometimes domestic mid-cap biotech is attractively priced, for example, and sometimes it isn't. And while we'd be the last people to jump on the bandwagon of whatever market trend is hot at the moment, we also don't like having to wait – possibly for many years – for one particular market segment to come back into fashion before we can start making money for our investors. In short, when the world changes, we think it's imperative to change with it. After all, if an investment manager hopes to evolve to succeed, handcuffing themselves in this way is just laugh out loud dumb. There really is no other way to put it.

## Crossroads' solution: A two-pronged approach with a go-anywhere mandate

While Crossroads is a value fund, our approach is more complex than simply buying businesses we think are undervalued and waiting for the market to eventually correct the mispricing. Instead, we follow a dual-pronged strategy:

+ First, we invest in well-run but undervalued businesses benefiting from powerful secular trends, with increasing competitive advantages and long runways to reinvest profitably at high returns on capital. We call these our Category One stocks. They're often undervalued because the market doesn't yet understand them, institutional investors can't yet touch them, and major indices don't yet include them. However, we believe the market will recognize their true value over time. Hospital revenue cycle management company R1 (ticker: RCM) is an example of one of these "Category One" stocks. While R1 has benefited from a variety of catalysts, at this stage of our investment we generally expect it will ebb and flow alongside the general market, trading up as its success becomes increasingly hard to deny, and the company's normalized earnings capacity becomes better known.

+ Second, we also own a basket of near-term tactical investments that stand to trade up in the near term on event-driven external catalysts. These opportunities usually arise due to idiosyncratic market dislocations or company- and industry-specific factors like mergers or regulatory changes. iGaming company GAN Plc is representative of these "Category Two" stocks. A classic special-situations play, GAN uplisted to the NASDAQ earlier this year (when we started building our position in the stock, in late 2018, it was trading on the London's version of the pink sheets). That event, combined with other factors,[5] kickstarted a liquidity-driven flywheel that ultimately sent its share price soaring.[6]

The takeaway is this: when it comes to delivering steady, long-term capital appreciation to our limited partners, combining these two investment approaches makes the whole of our portfolio greater than the sum of its parts. Our "Category One" stocks tend to follow the market's short-term surges and dips, but trade steadily upward over the longer term. On the other hand, our "Category Two" stocks can pay off handsomely when their catalysts hit and tend to display much less correlation with market moves. A behavioral characteristic that gives them superior risk-reward profiles in downturns. This latter point is particularly important. They may not go along for the ride in a momentum-driven bull market, but they tend to hold up well when sentiment reverses and investors crowd the exits.

All in all, we think this two-pronged approach is a pretty good idea. However, we didn't come up with it ourselves. As with pretty much every other aspect of the Fund's investment philosophy, we borrowed it from Warren Buffett and his early LPs.7

Which leads me to our next point. While Buffett today is known as the archetypal buy-and-holder., whose favorite length of time to own a stock is "forever". But in his early days, his limited partnerships followed a two-pronged investment approach that worked just as well for him back then as it does for us today. We're surprised that more people – even seasoned investment professionals – aren't aware of this, since it's arguably what got Buffett's immense wealth snowballing in the first place.

It's true that Buffett has always bought some stocks simply because they were undervalued, such as GEICO, Disney, and American Express. He called these "generals", and they correspond to our "Category One" stocks. However, it's much less widely known that he had another group of investments back then called "workouts." The name meant

(5) It's important to note that we didn't buy GAN simply because it was planning to uplist to the NASDAQ. The uplisting was merely the catalyst by which we believed the market would quickly come to recognize the company's true value. GAN also benefited from increasing operational momentum, favorable regulatory change in its main market, superior business and management quality, broader sell-side coverage, and other factors.

(6) GAN has been a huge success for the Fund. We multiplied our invested capital in it eightfold in less than two and a half years, despite the market's record-breaking volatility. Eventually, as price and value converged, we sold off all our holdings in GAN except for a small covered call position.5 It's important to note that we didn't buy GAN simply because it was planning to uplist to the NASDAQ. The uplisting was merely the catalyst by which we believed the market would quickly come to recognize the company's true value. GAN also benefited from increasing operational momentum, favorable regulatory change in its main market, superior business and management quality, broader sell-side coverage, and other factors.

(7) Are we somehow "cheating" by basing so much of our investment approach on what Buffett did? We don't think so, any more than a scientist cheats by basing his own research on the principles discovered by those who went before him. Indeed, Buffett himself based his value investing approach on the work of his mentors Benjamin Graham (known as "the father of value investing"), David Dodd, and Phil Fisher.

that he expected the stock to trade up once the company worked out some issue, problem, or deal. They were the equivalent of our "Category Two" stocks, and today stocks like these are commonly called "special situations" or "event-driven".[8]

So, Buffett wasn't just one of the first great value investors; he was also one of the first great special situations investors. In fact, much of his legendary ability to deliver consistent market-crushing returns was due – at least in those early years – to his workouts. They're why he told investors he expected to beat the market when it was weak, but to underperform when it was strong. Over the long term, however, buying generals and workouts let him generate higher returns than he could have achieved with either category alone, and with considerably less risk – just as it does for us today.

But using a two-category system isn't the only investment idea we've borrowed from the early Buffett LPs. We're also opportunistic generalists with a highly flexible mandate. That means we're free to hunt for low-risk, high-return securities across the investment spectrum, free from irrational constraints – just like Buffett was. As the following comments from him and Charlie Munger at the 2004 Berkshire Hathaway annual meeting make clear, Buffett had no interest in following arbitrary limitations on his investing style that would keep him from maximizing his investors' returns:

> Munger:
> "*If I was offered the chance to go into business where people would measure me against benchmarks, force me to be fully invested, crawl around looking over my shoulder, etc., I would hate it. I would regard it as putting me into shackles.*"
>
> Buffett:
> "*I would hate it. In 1956 when I started the Buffett Partnership, I passed out the ground rules, which said "here's what I can do and can't do." The idea of setting out to do what you know you can't do is terrible.*"

For Buffett (and Munger), there was no point in trying to make your investors as much money as possible if you were going to hamstring yourself right out of the gate with unnecessary restrictions. That view strikes us as eminently sensible. What's harder to understand is why so many other managers do hamstring themselves, arbitrarily limiting their investments to stocks of a particular type or category.

The answer is that many firms, managers, and investors are knowingly putting their interests first, usually by pointing to some version of modern portfolio theory (MPT) in hopes of disguising what's actually going on. For context, MPT is a theory pioneered by Nobel Prize-winning economist Harry Markowitz in 1952 that purports to explain how to build "efficient" portfolios that maximize returns for a given level of risk (or minimize risk for a desired level of return). Following MPT, an investor might invest in several different asset classes with various expected returns and risk levels. By diversifying a portfolio in this way, the investor should, in theory, be able to achieve a desired level of return with less risk than if she invested in a single asset class, because a gain in one asset class would be offset by a loss in another.

(8) Buffett actually considered himself to invest in three categories of stocks back then, not two: He drew a distinction between "workouts", in which the company was expected to work things out on its own, and "controls", in which he as a major investor would play an active role in making the workout happen. For our purposes, however, these two categories can be lumped together.

Our point here is simply that the rise of MPT has led many managers to position their funds as representatives of one asset class or sub asset class in hopes of maximizing their firm's AUM - and hence its earnings - at their investors' expense. Consider that today there are small-cap funds and large-cap funds, domestic funds and international funds, growth funds and value funds, tech funds, energy funds, healthcare funds, and many more. An investor can add positions in these various funds to his portfolio, balancing out a bit of large-cap with a bit of small-cap, some growth with some value, and so on. Sometimes these categories of funds are divided into different sections of a matrix called a "style box" – so the investor might choose one fund from the Growth column and the Mid-cap row, and another from the Value column and the Large-cap row. The idea is that by using risk and return projections for the asset classes (or sub-classes) that these funds represent, fund managers - and the army of investment advisors pushing them - can generate the highest possible return for the level of risk they are taking on.

There's just one problem: it doesn't work with the degree of precision its proponents would like it to. Sure, certainly historically speaking, buying bonds to counterbalance your stocks can be a sensible idea for some folks. But the idea that it's possible to reliably and precisely estimate risk and return levels over a defined period for a large number of finely-sliced asset sub-classes – let alone for particular funds – is laughable to anyone who's ever actually managed a portfolio.[9] And yet vast numbers of investment professionals have based their careers on the assumption that it can be done. As Charlie Munger has said, "The general systems of money management today require people to pretend to do something they can't do and like something they don't. It's a terrible way to spend your life, but it's very well paid."

At Crossroads, we don't play the MPT game. Candidly, we find the assumptions embedded into this industry standard framework fundamentally flawed. Which is to say that we don't believe volatility is risk - at least for investors with an owner's mindset, who truly think and act long-term. Nor do we put much faith in our ability to handicap the future at the macro level. Indeed, when it comes to all things macro, the proper approach is one of limited, due consideration with regard to the level of certainty we ascribe to our own conclusions. The future is always and everywhere uncertain, after all. And that's fine with us. Our talents lie in fundamental business analysis, not in making macro calls. Better to stick to what we do best: constructing a portfolio capable of doing well over 3- to 5-year intervals regardless of what the future holds.

And our approach certainly isn't designed to fit into a style box. We know that pigeonholing ourselves in order to appeal to brokers and wealth managers is a recipe for mediocrity. It's also just dumb. As Allan Mecham once said, "A manager limiting himself to the confines of a small style box to appease an asset allocation model is the equivalent of a basketball player focusing 100 percent of his game on a left-handed skyhook: while he has certainly carved out a niche for himself, he likely won't help his team win any games". Can I get an amen?

(9) The theory behind MPT – that diversifying among different types of investments can reduce risk – is sound. (Even we follow it ourselves, somewhat, by investing in two different categories of stocks, as we've explained previously.) The problem comes when it's expected to deliver unreasonably accurate results based on unreliable projections.

Of course, we find some hunting grounds more bountiful than others, but we don't restrict ourselves to them. For example, our "Category One" stocks usually have market capitalizations from $50 million to $5 billion and have limited institutional ownership, simply because they haven't been "discovered" yet. And yet one of our best-performing "Category One" stocks has been Nintendo, a huge, well-known company with widespread sell-side coverage. That's okay with us. We believe value is where you find it.[10]

Finding it, however, can be tough. While our Buffett-inspired investment approach may sound simple in theory, it's incredibly difficult to follow in practice. It takes sound judgement, thorough research, decisiveness, rigor, a killer work ethic, patience, not to mention a healthy dose of intestinal fortitude and courage, to get the job done. Without all that, we wouldn't be able to find and buy grossly mispriced assets before the crowd catches on. Not in good markets, let alone bad ones. Which is to say that it's a real challenge to identify stocks we think the market has gotten all wrong – and then have enough confidence in that view to back it up with our partnership's precious capital. Amazon founder Jeff Bezos put it best when he recently noted that "outsized returns come from betting against conventional wisdom, but conventional wisdom is usually right."[11]

It's instructive that the greatest investments we've ever made – the ones we look back on with awe – didn't feel great when we made them. We couldn't see into the future and know for sure that they were going to be winners. Indeed, in most instances, they were made when uncertainty and general sentiment about the risks to the health of the general economy had reached a fever pitch. After all, when markets are in freefall and it feels like the world is coming apart at the seams, it can be hard to stay the course, to put it lightly. Legendary fund manager Seth Klarman put it beautifully when discussing exactly this point, noting that "you aren't human if you aren't terrified you've just made a terrible mistake." Truer words have rarely been spoken.

Yet, ironically enough, those are actually the times we live for as long-term investors. We see periods of extreme uncertainty and gut-wrenching volatility as bargain-hunting heaven. On the other hand, we really start to worry in raging bull markets, when most investors seem to agree that stocks can only go up. The point is simply that maintaining high standards, a proper temperament, and perpetual vigilance against risk in all its forms requires real discipline regardless of the environment: if it's tough watching stocks you own go down, it can be even tougher watching stocks you don't own go up.

The good news is that some things never change. The greatest returns will always be earned by wading where the competition isn't, by following a go-anywhere approach not dissimilar from the underlying rationale of social distancing: beware the crowd. Thankfully we have the freedom to do exactly that.

(10) It's important for us to note that as great as a winner as Nintendo has been for us, it is responsible for a mere 14% of our total 200%+ since-inception return.

(11) Statement by Jeff Bezos to the U.S. House Committee on the Judiciary, Testimony before the Subcommittee on Antitrust, Commercial, and Administrative Law, July 28, 2020. https://blog.aboutamazon.com/policy/statement-by-jeff-bezos-to-the-u-s-house-committee-on-the-judiciary

## Industry Problem #3: Diluting the impact of "winners" through excessive diversification

We've talked about how most active managers are too focused on the short term, and too limited in their investment approach and universe. But that still doesn't fully explain why they can't beat the market, or at least an appropriate benchmark index. Shouldn't smart, experienced fund managers be able to pick some winners and outperform?

The answer is yes, they should. And in fact, they can. Several studies have shown that active managers produce persistent excess returns on their best ideas – and not just by a trivial margin. A study published just this past June by researchers at Harvard, the London School of Economics, and IESE Business School found that managers' top ideas outperformed the market by 2.8 to 4.5 percentage points in an average year.[12]

The problem is that most managers don't invest in only their best ideas. Instead, they build overly diversified portfolios that dilute the outperformance of their winners, which in turn pulls down their overall returns into the realm of mediocrity…or worse. Why would they do this? Because, as the authors of the study mentioned above explain, they're incentivized to do so, even if it hurts their investors:

> *"Our results suggest that while the typical manager has a small number of good investment ideas that provide positive alpha in expectation, the remaining ideas in the typical managed portfolio add little or no alpha. Managers have clear incentives to include zero-alpha positions. Without them, the portfolio would contain only a few names, leading to increased volatility, price impact, illiquidity, and regulatory/litigation risk. In particular, adding additional stocks to the portfolio can reduce volatility, increasing portfolio Sharpe ratio. Perhaps most importantly, adding names enables the manager to take in more assets, and thus draw greater management fees. The manager gains from diversifying the portfolio, but the typical investor is often worse off because they likely have only a modest fraction of their assets in any one fund."* [13]
>
> - Warren Buffett

In fact, overdiversification has an even greater negative impact on investor returns than the high fees that are so often blamed for actively managed funds' underperformance. But the managers that do it don't seem to care. They (and the brokers, investment advisors, and other people involved in running and marketing such funds) have apparently accepted this fundamental conflict of interest between them and their clients. They'd rather have a portfolio that is capable of attracting and retaining investors, even if those policies come at the direct expense of the long-term returns earned by the very individuals and institutions they supposedly serve.

We wish we were exaggerating, but sadly we're not. In reality, it's even worse than that as these tactics harm the very people the investment industry is supposed to serve. Consider the Sharpe ratio, mentioned in the prior section as well

(12) Miguel Antón, Randolph B. Cohen, and Christopher Polk. Best Ideas (June 30, 2020), p. 4. Available at https://www.hbs.edu/faculty/Publication%20Files/21-004_f616ddeb-db44-495b-915a-0b5191d9ccf3.pdf.

(13) Ibid, p. 2.

as in the extended quotation above. As already noted, the ratio supposedly measures the level of a portfolio's returns to the riskiness of those returns.[14]

But all else isn't equal. Often, a manager can generate much higher risk-adjusted returns by tolerating higher volatility in his portfolio. And again, volatility is not risk for the long-term investor. Risk is permanently losing money or in some cases, earning an inadequate return. This is just simple common sense, but stick with me for a moment. Our point is that said manager would be punished for what is an obviously superior outcome, because by taking on that higher volatility his portfolio's Sharpe ratio would likely fall. That's Step One. Step Two comes when the lower Sharpe ratio costs his fund a star or two in the Michelin Guide-like star ratings issued by Morningstar and other companies. Then, in Step Three, the lower star ratings keep his fund from popping up in the selection screens of investment managers and individual investors. That brings us to Step Four, in which the flow of money into his fund begins to dry up and existing investors pull money out. Finally, we end at Step Five, in which the manager, whose compensation is geared to how much money he's managing, now gets paid less than he used to. So, it's understandable that many managers aim to keep their Sharpe ratios nice and high, even if it means generating lower returns for their existing investors. Once again, Charlie Munger said it best:

> *"I think the reason why we got into such idiocy in investment management is best illustrated by a story I tell about the guy who sold fishing tackle. I asked him, "My God, they're purple and green. Do fish really take these lures? And he said, "Mister, I don't sell to fish." Investment managers are in the position of that fishing tackle salesman."*

## Crossroads' solution: A portfolio concentrated in a few best ideas

We're sure that if we expanded our portfolio to fifty stocks – let alone a few hundred – we'd have plenty of losers and run-of-the-mill picks undermining the big gains of our highest conviction ideas. Our solution to the problem of overdiversification is simple: we invest in only our best ideas.

Of course, that means that our returns don't always track closely with those of the market or our benchmarks. For one thing, they may be more volatile in the near term. And that's fine with us. The Fund is not a broad-based index and it isn't meant to perform like one. It's a carefully curated selection of our very best investment ideas, built one at a time as opportunities present themselves. Our performance reflects the combined outcomes of those ideas, not those of the market or our benchmarks.[15] That not only makes it easier for us to beat the market, it also makes the Fund less susceptible to market gyrations and macro pressures than broader-based equity funds.[16]

For example, in 2019, despite our conservative positioning, and despite small-cap value equities facing significant headwinds, we generated strong returns. Even with credit-related macro hedges and a large cash reserve diluting our

(15) Technically, the Sharpe ratio is the ratio of a portfolio's average return in excess of the risk-free rate of return, divided by the standard deviation of that excess return. We know this stuff, but we didn't want to bore you with it.

(16) Of course, "less susceptible" doesn't mean "immune". We fully expect the Fund to experience substantial volatility from time to time, especially during sudden market panics and violent changes in short-term sentiment. But it does mean our long-term returns shouldn't depend on how the S&P is doing.

results, we still managed to outperform.[17] And, as you might expect, our strong 2019 results were mostly driven by just a few of our largest, highest-conviction ideas: Nintendo, R1, and GAN Ltd, representing half of the Fund's total assets at year end, returning 51%, 63%, and 295%, respectively.

Isn't it irresponsible to invest in just a few stocks? What if they don't do well? Don't you need some diversification? Yes. Yes, we do. Just not so much as you might think. Study after study has shown that investors get almost 80% of the benefits of diversification by owning just eight stocks and get over 90% of the benefits by owning twenty stocks.[18] So, diversification is not a valid rationale for owning dozens and dozens of stocks, as most funds do. Instead, as we've shown above, it's a recipe for structural underperformance that leaves investors worse off.

Even if there were a diversification benefit to owning vast numbers of stocks, it's simply impossible for a single manager to develop and maintain rich, intimate understandings of so many different companies at the same time. Show us a manager who owns fifty stocks and we'll show you a manager who doesn't personally understand more than ten or twenty of them in intimate, up-to-date detail.

Okay, but what if there were a diversification benefit to owning lots of stocks and we could somehow maintain deep, intimate understandings of all of them? We still wouldn't do it, and that's because most of them would probably be mediocre investments or worse. If there's one thing we've learned in this business, it's that great ideas worthy of outsized positions are extraordinarily rare. It takes hard work and determination to find them. If we find three or four truly great ideas a year, we're ecstatic. It's simply not believable that most of our peers can find fifty and properly monitor them all.[19]

But let's suspend reality just a bit more. What if there were a diversification benefit to owning lots of stocks, and we could monitor all of them adequately, and they were all amazingly great ideas? Well, even then, we still wouldn't do it. Even if we could find fifty exceptional ideas, owning all of them would reduce the contribution any one of them could make to our long-term returns. The way we look at it, if we're going to do all the hard work necessary to search for great investments, we should make sure they really pay off for us when we finally find them.[20] If we owned fifty stocks, we'd have an average of just 2% of our portfolio in each of them. So, any one success would have only a minor impact on our performance overall.

(17) Ironically, we actually expect to underperform in years like 2019. Our approach, like Buffett's, isn't designed to outperform during bull markets – especially during growth-led, momentum-driven bull markets in which fundamental analysis can seem quaint, if not entirely irrelevant.

(18) Of course, investors get those benefits only if the stocks they pick don't have a high degree of positive correlation with each other. For example, a portfolio comprised solely of eight gold mining stocks or eight energy stocks would probably not represent adequate diversification. A portfolio of eight stocks from different sectors might, though.

(19) And, in fact, they can't, as the Best Ideas study we quoted above demonstrates.

(20) Smaller positions can be beneficial in highly asymmetric situations where the potential payoff compensates for the risk of total loss – but that's a special case.

We don't like minor impacts. We like major impacts. Consider our outsized position in Nintendo, which currently represents 15% of the Fund's NAV. We're up roughly 100% from our average cost basis in the stock, and we still think it's unsustainably cheap. Indeed, we've yet to sell a single share. It's not often that the market hands us the chance to invest in a business of this quality and long-term growth potential at a single-digit multiple to its normalized earnings power and a fraction of its theoretical liquidation value. And as Charlie Munger once advised, "When you get a lollapalooza, for God's sake don't hang by like a timid little rabbit". Luckily, we took his advice. Rather than nibble, we went for a full-on feast.

So that's why we don't own fifty stocks. The average mutual fund owns about eighty stocks – which helps explain why most mutual fund managers don't beat their benchmarks. Even if a portfolio like that has a few big winners, chances are it has some real stinkers in there too, dragging returns down. It's hard to beat a benchmark when you're more or less replicating it – and with much higher transactional costs to boot.[21]

## Industry Problem #4: Getting too big for good ideas to make an impact.

Because managers are usually compensated at least partially in proportion to their AUM, they have a financial incentive to see their funds grow as large as possible.[22] However, the larger a fund grows, the harder it becomes to find good investments for its portfolio.

To see why, let's imagine a hypothetical company, WidgetCo, with a $600 million market cap. After diligent analysis, Manager A concludes that at fair value its market cap should be $900 million, a 50% increase. His fund has $100 million under management, and he decides to go big: He buys $25 million worth of WidgetCo stock, acquiring 4.2% of the company and making it 25% of his portfolio. By next year, WidgetCo shares have traded up 50%, as he expected. He closes out his position, realizing a $12.5 million gain and a 12.5% increase in his portfolio's total value.

Now let's walk through that scenario again, but this time with Manager B, who runs a fund with AUM of $2 billion. The same $25 million investment in WidgetCo would represent a paltry 1.25% of his portfolio. Even if his position doubled or tripled in value, it would have a tiny impact on his total returns. But what if he decided to take a much larger position and make WidgetCo 25% of his portfolio, as in the previous walk-through? Well, he probably couldn't. He'd need to buy $500 million of WidgetCo stock – or almost the entire company. Moreover, even if the company were large enough for him to buy billions of dollars' worth of its stock, he might find it hard to scoop up that many shares on the open market without driving the price up – and equally hard to sell that many shares without driving the price down. Like Hotel California, he can check in, but absent a sale of the entire company, he can't check out. He might also run into regulatory issues associated with acquiring a large, or even a controlling, stake in the company. So, while WidgetCo would be one of the all-time great successes for Manager A, it wouldn't be worth the trouble for Manager B.

(21) To be fair, mutual fund managers (unlike our hedge fund manager peers) do face regulatory limits on maximum position size. That means they have a valid excuse for owning lots of stocks. But it also means we have a huge advantage over them when it comes to generating high returns for our investors.

(22) As we'll discuss later on, we aren't compensated in this way, so we don't have this incentive.

## Crossroads' solution: Stay small.

At Crossroads, we're committed to always being Manager A. It's hard enough to find great ideas without having to reject lots of them because we've let the Fund swell to gargantuan proportions. And while we haven't set a hard limit on how large we'll allow the Fund to get, we have decided on this: if we ever get to the point where we can't find enough great, needle-moving ideas to make us confident about delivering a 15% net IRR to our limited partners, we'll close the fund to new investors and start handing back money until we can. We estimate our ideal amount of AUM would probably be in the vicinity of ~$400 million, so we don't expect to have to close the Fund any time soon. But when that day comes, we'll know what to do.

## Industry Problem #5: Fickle investors

At this point, you might think we've ironed out all the wrinkles that constrain other actively managed funds:

+ We take a long-term view, so we don't panic when times are tough.
+ We don't limit ourselves to a single investment approach, so no stock or situation is off limits when we're searching for value.
+ We don't overdiversify, so when our investments pay off, they really make a difference.
+ We will remain relatively small, so that we can access and scale up any investment.

However, one problem remains: investors in most funds are fickle. They're influenced by the latest results, not the big picture. They'll invest in Fund A today, but redeem and invest in Fund B tomorrow, either because they're following the hot new trend, or because they believe their portfolio needs to be rebalanced. And it's not just layperson retail investors who do this. Sophisticated institutional investors who should know better can be just as guilty of such short-termism.

Of all the challenges that an investment partnership faces, solving "the fickle investor problem" is the most important because it gets right at the heart of all of the others. Money managers are forced to obsess about the short term because if they don't, investors will pull out their money and go elsewhere. They're forced to stick to a particular investment style so they'll be marketable to investors looking to fill slots in a style box. And they're forced to overdiversify so they won't be too volatile, keeping their star ratings high enough to attract investors searching for top-ranked funds. Without solving the fickle investor problem, we wouldn't have been able to execute our investment strategy at all. We solved it by – once again – looking to a young Warren Buffett for inspiration.

## Crossroads' solution: Stay small.

From the very beginning, Buffett realized that his ability invest – to think and act clearly, to maintain a healthy state of mind, to conduct effective, high-quality research, and to take a long-term view – meant that he'd need to limit participation in his LP to a particular kind of investor. He needed people who wouldn't be looking over his shoulder and questioning how or when he swung the bat, knocking him off-kilter every step of the way. He couldn't afford to take on second-guessers who lacked the temperament and mindset to stick with him for the long haul, who would rush for the exits if the market hiccupped – or even if he posted a few years of relatively poor returns.

In short, he needed investors who believed in him and what he was doing. And he knew that by letting only that kind of investor on board he was acting in everyone's best interest, not just his own. Indeed, investors like these would come to be his most significant competitive advantage: a stable, dependable foundation of capital on which returns could be built.

Because we modeled Crossroads so closely on those early Buffett LPs, we knew the same thing would be true for us. We had to find investors who not only understood our investment philosophy and approach, but who took a long-term view themselves. Four years later, we can say unequivocally that our limited partners have exceeded our wildest expectations. As COVID-19 fears struck around the globe, they made multiple additional investments in the Fund that let us take a historic market selloff in stride. And amazingly, this wasn't a one-time special occurrence: the same exact thing happened when the market nosedived in the fourth quarter of 2018.

Then, as now, we could only marvel at these incredible people, and how lucky we are to have them in our corner. With 99% of managers paralyzed by the fear that their AUM might walk out the door the next day, we were free to sift through the rubble for 50-cent dollar bills. And because so many managers were sidelined, there were plenty of opportunities for us to exploit.

Moreover, moments like those validated our decision to sacrifice fund size for investor quality. It was hard – really, really hard – for us to turn down capital when our fund was even smaller than it is now. We're extremely fortunate to have investors who understand why being so picky is absolutely necessary. Indeed, none of what we've achieved would have been possible without the confident backing of our limited partners. Collectively, they're our greatest asset, and they have our sincere gratitude for their trust and support throughout the Fund's early years.

But what attracts long-term investors like them to a fund – and what weeds out the fickle investors who would possibly corrode, if not torpedo, its performance? Below, we discuss how Buffett achieved both goals with his early LPs – and how we've followed his blueprint.

## How Buffett Weeded out Fickle Investors

Sure, it's easy to force investors to stay in your fund for a given length of time by using the brute-force tactic of a lock-up period – but once the lock-up expires, all bets are off. So, Buffett took a couple of clever steps that induced fickle investors to self-select out of his early LPs. We've followed his lead.

The lack of a fancy office and glossy brochures didn't hold Buffett back. By the mid-60s, his performance was already the talk of Omaha, and rightfully so: A dollar invested with him in 1957 had turned into $30 before fees and $26 after by the time his partnership wound up in 1969.

Put another way, then, marketing is what you need when you can't realistically offer the promise of great performance. Indeed, a platoon of well-groomed salespeople in fancy suits – people who look like Hollywood's image of a successful Wall Streeter – is as contrary an indicator as a firm can give. If you ever encounter a marketing team like this, don't just walk away, run! They're why so many affluent but unsophisticated investors park their assets with glamorous "private client groups" at bulge-bracket banks, only to end up earning so-so returns.[27]

Indeed, part of the problem with marketing is not just that it takes time away from finding great stocks, but that it tends to attract fickle investors. We can't prove this with hard data, but it seems to us that the investors most likely to be swayed by "star ratings" and sales pitches are also most likely to focus on short-term results and to hop in and out of various funds at exactly the wrong time. If not "marketing" the Fund in this manner helps us steer clear of folks like that, so much the better.

At Crossroads, then, we're determined to follow Buffett's lead and let our returns speak for themselves. Our fund manager works out of his second-story walk-up rental in Kansas City, and our analyst (who doubles as our operations manager) works in a small office room he built in his own basement. We have no assistants, no support staff, and no salespeople. Again, all of this is by design.

## Attracting long-term investors

We've discussed how Buffet avoided the investors he didn't want. But how did he attract the long-term-focused investors he did want? The short answer is that he made sure his financial interests were fully aligned with theirs, so that when he won, they won. He took several steps to make sure that this would be the case, and we've again followed his example.

Entire net worth in Fund. Managers with most or all of their net worth invested in their own fund are in the same boat as their investors. On the other hand, managers with little – or even none! – of their net worth invested in the funds they manage are merely watching from the shore. If you've read this far, we bet you can guess which kind of manager Buffett was when he was running his early LPs.[28]

Apart from our highly illiquid ownership interests in Crossroads Capital LLC, the Fund's general partner, we have our entire net worth invested in the Fund, right alongside our limited partners' capital. That means it's in our interest to have the Fund generate the highest risk-adjusted long-term returns possible. Our financial future depends on it.

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Joel Greenblatt, Burry felt he should dress up for the occasion. He ditched his typical t-shirt, shorts, and flip-flops for a suit, tie, and loafers – only to find that Greenblatt had showed up in sweatpants.

(27) There's nothing wrong with owning nice things or taking pride in one's appearance. But ideally, the clients of these sales teams should be equally able to afford a life of luxury, if not more so. We recommend our partners read or revisit Fred Schwed's classic Where Are the Customers' Yachts? It was first published over 50 years ago, but few books better (or more hilariously) expose the hypocrisy of investment professionals who get rich while their clients lose money.

(28) If you guessed "the kind with his entire net worth invested in his fund", congratulations.

Symbiotic fee structure. Even with his entire net worth invested in his early LPs, Buffett's financial interests might still not have been fully aligned with those of his investors. That's because fund managers earn fees for their work, and how those fees are calculated can create a massive conflict of interest between them and their clients.

For example, most mutual funds charge investors a percentage (1% is typical) of their assets under management as an annual management fee. If you have one million dollars invested in their fund, you'll pay them ten thousand dollars for managing your money that year. If they do a great job and your investment increases in value to two million dollars the next year, you'll pay them twenty thousand. Sounds sensible, right? After all, the manager would clearly rather make twenty thousand dollars than ten thousand, so he's incentivized to grow the value of your investment, isn't he?

Not exactly. The manager doesn't have to make that extra ten thousand from your million-dollar investment increasing in value. He can just as easily – in fact, much more easily – make it by taking in another million dollars from new investors. That way, he'll get paid more even if his returns are flat. So what he's really incentivized to do is take in as much new money as possible, instead of ensuring his returns are as high as possible.[29] And when a manager's main goal is gathering and retaining new money, he's more likely to engage in all the investor-harming practices we discussed earlier, such as focusing on short-term results, overdiversifying to reduce volatility, and so on.

At Crossroads, we've carefully designed our fee structure to eliminate that potential conflict of interest. Like many funds, we do collect an annual management fee – ours is 1.5% of our assets under management. However, once those assets under management reach $66.7 million, that fee is capped. It will never be even one penny more than that amount ($1 million), no matter how large the Fund becomes. It also means that we have no financial incentive to make the Fund as big as possible, welcoming in new investors at the expense of the old.

We also need to incentivize ourselves to make our existing investors wealthy, and we've done that by charging a performance allocation. Our performance allocation (20%, subject to a high-water mark and stepping up to 25% once we reach $66.7 million in AUM) comes out of the gains we generate for our investors. No gains, no fee.

Of course, we're hardly alone in adopting this approach. Indeed, most hedge funds use performance allocations. Where we stand out is in capping our management fee, as described above. It's all well and good for a hedge fund manager to say his financial interests are aligned with those of his investors because he takes a performance allocation. But if his management fee continues to increase along with his AUM, then he's exposed to the same temptation we discussed earlier: the temptation to grow his fund by taking in as much new money as possible, rather than by generating gains for his existing investors. By capping our management fee, we avoid that temptation. As the Fund increases in value, our fee structure gets closer and closer to "zero and 25" – a management fee asymptotically approaching zero percent, and a performance allocation of 25%.

By this point, it probably won't surprise you to learn that "zero and 25" is the fee structure Warren Buffett eventually adopted for his early LPs.

(29) Of course, having high returns is the best way to attract new money, so if a manager's returns are flat, he might find it hard to draw investors into his fund. But, as we've discussed above, that's why so many funds need to rely on marketing to drum up business.

By this point, it probably won't surprise you to learn that "zero and 25" is the fee structure Warren Buffett eventually adopted for his early LPs.

No distributions. Another step Buffet took to attract long-term investors was to lead by example. He knew that if he wanted his investors to keep their money in his fund, he had to demonstrate that same behavior himself.

We've already discussed how Buffett invested his entire net worth in his early LPs. But he actually went a step further: he didn't take any distributions from the performance allocation he earned managing those LPs. What that means is that every time he earned a performance allocation for generating positive returns, he left that money in the fund instead of pulling it out and spending it or investing it elsewhere. He could have easily argued that the performance allocation, as his compensation, was his to do with as he pleased, and he would have been right: he had no obligation to keep his performance allocations invested in the funds that generated them. But he knew that doing so would send a powerful message to his investors: "There's no place on earth I'd rather put my money than right here in my own fund with yours."

This is another of Buffett's early fund management principles that we've been eager and proud to follow. Since Crossroads' inception in June 2016, we have yet to take out a single dollar of carried interest, and we have no plans to do so for the foreseeable future.

Meaningful yardsticks, chosen in advance. As we've discussed, Buffett didn't provide updates on his performance very often. But when he did, he insisted on showing his returns over a substantial time period and placing those returns in the proper context. He did this because to him, active management as a profession was being corrupted by lax reporting requirements. When touting their results, managers commonly chose those time periods over which their performance looked best. Similarly, if they measured themselves against any peers or benchmarks, they selected those that would yield the most flattering comparisons.30

We suspect this practice offended Buffett's sense of fairness and intellectual honesty, a sense that explains much of the radical candor of his communications with investors from the very beginning through to the present day. He knew that the only way investors can know how a manager is doing (and, indeed, the only way the manager himself can know how he's doing) is if the manager measures himself against an appropriate yardstick for a significant length of time. What's more – and this is key – the manager ought to select that yardstick and time period in advance. Finally, he knew that providing meaningful data in this fashion was crucial to attracting serious, long-term-minded investors – people who wouldn't be swayed by a flashy tear sheet full of cherry-picked results.

For Buffett, this meant showing his results over three- to five-year periods that included both good years and bad, with the results of relevant benchmarks and peers provided for comparison. As he explained in the "Ground Rules" section of his first annual letter, way back in 1956:

(30) We see this type of thing all the time. If we had a dime for every time we've seen other managers cherry-pick a flattering comparison set after the fact, the coins would stack up to the sky.

1. *"Whether we do a good job or a poor job is not to be measured by whether we are plus or minus for the year. It is instead to be measured against the general experience in securities as measured by the Dow Jones Industrial Average, leading investment companies, etc. If our record is better than that of these yardsticks, we consider it a good year whether we are plus or minus. If we do poorer, we deserve the tomatoes."*
2. *"While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance. It is a certainty that we will have years when the partnership performance is poorer, perhaps substantially so, than the Dow. If any three-year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market."*

It should come as no surprise that at Crossroads, we follow these general guidelines in assessing our own performance. That's why it's only now that we're offering our first-ever "report card" on the Fund since launching it back in June 2016. After all, by now we've not only built a four-year track record, we've also navigated two severe market corrections. It's time to see how we've done.

## CROSSROADS' FIRST REPORT CARD

Adopting Warren Buffett's policies was no guarantee that we'd get his results. As Tess McGill's friend Cyn told her in the 1988 movie Working Girl, "Sometimes I sing and dance around the house in my underwear. Doesn't make me Madonna."

So, with our first four years in the books, it's time to see how we stack up against some of the all-time actively managed fund champs.

Annualized gross returns and outperformance (%), June 2016-May 2020

| Fund | Portfolio Managers(s) | Annualized Return | Benchmark | Benchmark's Annualized Return | Outperformance vs. Benchmark |
|---|---|---|---|---|---|
| **Crossroads Capital** | **Ryan O'Connor** | **22.39** | **Russell Microcap** | **4.89** | **17.50** |
| Pershing Square | Bill Ackman | 22.64 | S&P 500 | 9.77 | 12.87 |
| Wasatch Micro Cap | Daniel chase<br>Kenneth A. Korngiebel | 22.98 | Russell 2000 Growth | 10.63 | 12.35 |
| Akre Focus | Charles T. Akre<br>John H. Neff<br>Chris Cerrone | 20.34 | Russell 1000 Growth | 17.71 | 2.63 |
| Berkshire Hathaway | Warren Buffett | 7.12 | S&P 500 | 9.77 | -2.65 |
| Third Point | Daniel S. Loeb | 4.55 | S&P 500 | 9.77 | -5.22 |
| Gotham Absolute Return | Joel Greenblatt | 2.66 | S&P 500 | 9.77 | 7.11 |

Not bad at all, it turns out.[31] We've managed to compete with and beat some of the greats in today's active management space, posting considerable outperformance after tallying up recent results.

However, we weren't entirely fair to Buffett in that table above. As a small emerging hedge fund, we should really compare our performance to his not from his last four years at Berkshire Hathaway, but from his first four years running the early Buffett LPs. As we've mentioned, those years were part of his most impressive stretch of relative outperformance, in part because he was managing much smaller sums of money.[32] So, as you might expect, looking at the returns of the Buffett Limited Partnership over its first four years gives us a much more realistic sense of how we measure up to one of the investing world's all-time greats:

### Annualized gross returns and outperformance (%)

| Fund | Portfolio Managers(s) | Time Period | Annualized Return | Benchmark | Benchmark's Annualized Return | Outperformance vs. Benchmark |
|---|---|---|---|---|---|---|
| Buffett LP | Warren Buffett | Jan 1957- Dec 1960 | 24.53 | DJIA | 5.38 | 19.15 |
| **Crossroads Capital** | **Ryan O'Connor** | **Jun 2016-May 2020** | **22.39** | **Russell Microcap** | **4.89** | **17.50** |

So close! Oh well. In this case, we're delighted just to be holding our own. But we still haven't been completely fair to Buffet, because in his early days benchmarks like the Russell indices didn't exist. He measured himself against the leading market index of that era: the Dow Jones Industrial Index. Today, that role has been taken over by the S&P 500, so let's see how we did relative to the S&P:

### Annualized gross returns and outperformance (%)

| Fund | Portfolio Managers(s) | Time Period | Annualized Return | Benchmark | Benchmark's Annualized Return | Outperformance vs. Benchmark |
|---|---|---|---|---|---|---|
| Buffett LP | Warren Buffett | Jan 1957- Dec 1960 | 24.53 | DJIA | 5.38 | 19.15 |
| **Crossroads Capital** | **Ryan O'Connor** | **Jun 2016-May 2020** | **22.39** | **S&P 500** | **9.77** | **12.62** |

(31) All of the tables in this section are based on gross returns, in order to present more meaningful comparisons of investment performance between managers of mutual funds, which have no performance allocations, and hedge funds, which do. In other words, we want to isolate relative outperformance due to a manager's stock-picking ability, unaffected by his investment vehicle's particular fee structure. And relative outperformance is far more noteworthy than total return in terms of making sense of a manager's investment achievements. Finally, it's the long-term margin of relative outperformance over our passive and active competition that makes me confident we're earning our fees. After all, our investors can earn benchmark returns without paying an active management fee, so this exercise shows what they're actually getting for their money.

(32) In fact, all of the funds in these tables are considerably larger than Crossroads, and that goes a long way toward explaining why we've been able to outperform them. We don't think we're smarter or more insightful than the managers of these other funds. But we do think that our small size at this stage of the game gives us a tremendous advantage over them. So it's true that putting our performance up against theirs isn't really a fair comparison – but we're fine with it being unfair in our investors' favor.

Oof. Not as well, clearly. But while we might not be ahead of Buffet on relative outperformance, or even all that close to him, we're thrilled just to be in the same ballpark (and no matter how you slice it, crushing the S&P over a four-year time period is not too shabby).

So, we've done pretty well compared to some leading active managers and the S&P 500. But that might be because we focused on different parts of the market than they did. After all, if you go fishing in the ocean, you're going to do better than someone who goes fishing in the desert. So, let's see how we've fared since inception against our own benchmarks, two indices that focus on value and on smaller-cap stocks just like we do:[33]

Gross returns (%) from inception (June 6, 2016) through end-October 2020

| | Year to Date | Trailing 12 months | Trailing 3-year *(annualized)* | Since Crossroads' Inception *(annualized)* | Since Crossroads' Inception *(cumulative)* | Crossroads' Relative Annualized Outperformance |
|---|---|---|---|---|---|---|
| **Crossroads** | **69.71** | **82.16** | **30.74** | **30.05** | **219.20** | – |
| Russell 2000 Value | -18.60 | -13.95 | -4.15 | 3.28 | 15.30 | **26.77** |
| Russell Microcap | -6.78 | 2.90 | 0.34 | 7.06 | 35.16 | **22.99** |
| S&P 500 | 1.21 | 7.65 | 8.29 | 10.56 | 55.78 | **19.49** |

While our benchmarks and the S&P are recognized as tough long-term competitors, we've beaten them all handily. The vast majority of active managers don't. According to Morningstar, less than one-tenth of one percent of US equity funds with at least a four-year track record managed to outperform their benchmarks by an annualized rate greater than ten percent. We beat ours by fifteen. In fact, as of end-October 2020, we beat our benchmark by a greater margin than 99% of all the actively-managed funds tracked by Morningstar – not just our value-oriented peers focused on small- and micro-caps. That's good enough for us.

So, four years in, that's where we stand. We're not about to knock Warren Buffett off anyone's list of the all-time greatest fund managers, but we're not just dancing around the house in our underwear, either.

## Looking ahead

You might think that after a great run these past four years and counting, we'd be worried about a change in our fortunes. It's true that if the setup we were handed this past March was something that comes along only once in a generation, we're now looking at more of a "once-in-a-decade"

(33) While the Russell 2000 value and Russell Microcap indices aren't perfect comparisons for us (and neither is anything else), they are long-running, widely known measures of performance reflecting the general experience of small-cap and value investors. Moreover, they show the highest correlation to the Fund out of the major indices, and thus represent its proper comparison set. Finally, I believe they will continue to outperform the vast majority of actively managed mutual and hedge funds. As the data below illustrate, these indices (and, of course, the S&P 500) are hardly pushovers.

scenario. But in our book, that's still worth getting excited about. In fact, with our owner's mindset and multi-year outlook, we think that the Fund's next four years of performance may very well prove to be even stronger than its first four.

As I type this in early November, mispricings in the small and microcap space remain enormous. We have plenty of firepower on hand, with roughly 15% of the fund in cash after liquidating investments where the gap between price and value had closed. All but one of our positions are highly scalable. And we're close to wrapping up our due diligence on two highly attractive new investments. Their earnings power is set to grow substantially in the year ahead, but the market is pricing them as if it will be cut in half.

How can we be so optimistic? After all, haven't the major indices have largely recovered from their lows of earlier this year? Yes, they have. However, dispersion has reappeared across the investment spectrum. Valuation spreads within our preferred asset class are historically wide. And implied volatility across the small-cap sector has gone through the roof. Conditions like these are tailor-made for stock pickers who make good tactical use of options and operate in highly inefficient market niches. In other words, they're tailor-made for us.

What all this means is that if you're willing to look out five years and beyond, we think now is an excellent time to add to your investment with us, or to join the partnership. In fact, in over four years of running the Fund, this is only the second time we've advised jumping in with both feet. (The first was in November of 2018, after a heavy market selloff.)

## CONCLUSION: A PERSONAL NOTE

I've talked a lot about our admiration for Warren Buffett in this letter, and how we modeled Crossroads after his early limited partnerships. But I actually began studying Buffet's methods long before founding Crossroads, and that's because of my own personal connection to Buffett and his early LPs: my grandfather, Bill O'Connor.

Bill was an IBM salesman and, as it happens, an old poker buddy of Buffett's. His eternal claim to fame at IBM was that he'd managed to sell the famously tight-fisted Buffett his first typewriter. He was smart, ambitious, thrifty, hardworking, and above all, willing to learn. A few classes at the University of Nebraska's Omaha campus under Buffett's tutelage ensured he would not only learn a lot about investing, but also that he was hooked (I'm sure quite a few of you reading this now can relate).

He embraced the concept of a margin of safety, the miracle of compound interest, and the power of contrarian thinking. He was fascinated that it was possible to buy shares in a business at massive discounts to their readily ascertainable intrinsic worth. He didn't agree with Buffett about everything, but when it came to investing, he regarded him with nothing but admiration, bordering on awe.

As just one example, I can still remember the light in my grandfather's eyes when he talked about Buffett. He would regale me with stories of how Warren would make all kinds of brilliant connections, boiling down abstract financial topics into simple concepts anyone could understand. I was in early high school the first time he told me those stories, but one of the things that has always stayed with me was the sincerity in his voice.

Naturally, he jumped at the chance to become an early investor in the Buffett LPs, eventually rolling over his partnership interest into Berkshire Hathaway. It's a story that's familiar to all of you to one degree or another. But what some of you may not know are some of the details that underpinned my grandfather's decision to invest. For example, he had to sell his stock in IBM (the Apple or Google of its day) in order to meet Buffett's $25,000 minimum investment threshold – roughly $100,000 in today's money. He came up quite a bit short, at about $18,000, but Buffett graciously let him in anyway.

It was a bold decision. My grandparents, who had six kids at that time and would eventually add four more, were committing their entire saving to a new partnership run by some young kid no one had heard of. Buffett was an unknown then, even in Omaha, a socially awkward twentysomething. His shirts were wrinkled and ill-fitting, with fraying cuffs. This was a pre-toastmaster's Warren, long before he became the master of the crowd he is today. Safe to say, from the outside looking in, the optics of investing looked positively insane. After all, there was no way to tell that he would eventually become known as arguably the greatest investor of all time.[34] If there were ever an instance where optics and reality were two very different things, this was it.

Bill and Jean in the mid-1950's

To drive this point home, note that when my grandfather told my grandmother Jean he was planning on liquidating their savings, which had been earmarked for their kids' college tuition, my grandmother broke into tears. (Don't worry! Things turned out just fine!) While she eventually became one of Buffet's biggest fans, it's hard to blame her for that immediate reaction. At the time, IBM was the bluest of blue chips, not just a tech leader, but essentially the technology industry itself. Selling IBM it to go all-in with an unproven new fund manager was virtually unimaginable.

So, for those reasons alone, it was a move my grandfather didn't take lightly. He believed in IBM. But he believed in Buffett too, and for him that was enough. As for what people around him thought about his decision, he couldn't have cared less. Indeed, one of the many things that stands out for me in our discussions over the years was how he felt going with Buffet was ultimately an easy call.

All of which is to say that if my grandfather got his first real lessons in investing from Buffet, I got mine from him. They started as far back as I can remember. His early lessons were simple and full of "the acorn grows into a tree"-style metaphors; eventually we moved on to the Rule of 72 and more advanced topics. I heard them all more times than I can count. For my tenth birthday, he gave me a copy of The Richest Man in Babylon. I could go on. My point is merely to highlight that it's no exaggeration to say that if my grandfather hadn't befriended Buffett long ago, I wouldn't be here running Crossroads today. I am lucky beyond measure, of that much I am sure.

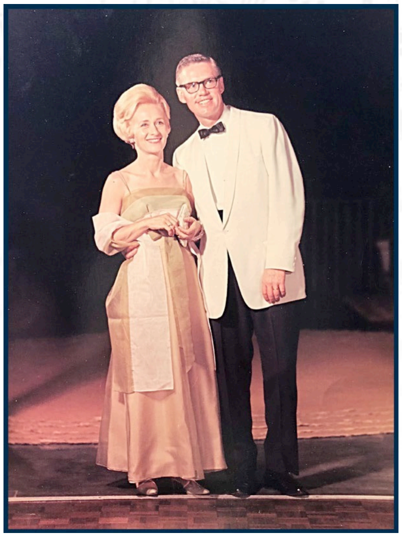
(34) My grandfather at the time was quite young himself. He was just a few years Buffett's senior (and was much younger than I am now, which blows my mind). Perhaps their transaction could only have taken place between two people like themselves, who both still had the heedless optimism, if not the outright recklessness, of youth.

Years later, when I was fresh out of college, I asked my grandfather why he had never diversified his investments away from Buffet's LPs and Berkshire Hathaway. What gave him such incredible confidence? After the umpteenth doubling of his money, why hadn't he taken some profits off the table? Why hadn't he listened to the dozens of solicitous investment advisors who told him year after year, decade after decade, that it was well past time to start diversifying his portfolio?

His answer couldn't have been any simpler.

"Ryan," he said, "if you knew Warren, you wouldn't ask that question."

In that moment I realized my grandfather had just given me one more lesson on investing, and this one was perhaps the most important of them all. It was a lesson on what real, earned conviction looked like, on how hard it is to find investments – or people – worth sticking with for the long haul, and on how important it is to actually stick with them if you do. How many people who bought Walmart back in the 1970s (or Microsoft in the 80s, or Amazon in the 90s, or Netflix in the 2000s) had the foresight and wisdom to hold on for a decade or more?


The Berkshire rollover era

As an investor, I've learned that while it can be hard to know when to buy and when to sell, it's hardest of all to develop the conviction that allows you simply to hold – and that's how the real money is made. You have to develop insights, connect the dots, and see the runway, all while never giving in to self-doubt, boredom, or even the ever-present temptation to simply do something – as if this were a discipline where results are determined by activity or effort, rather than by just being right.[35] It's a formidable challenge, but whenever I feel my resolve start to weaken, I need only think back to my memories of my grandfather for inspiration.[36]

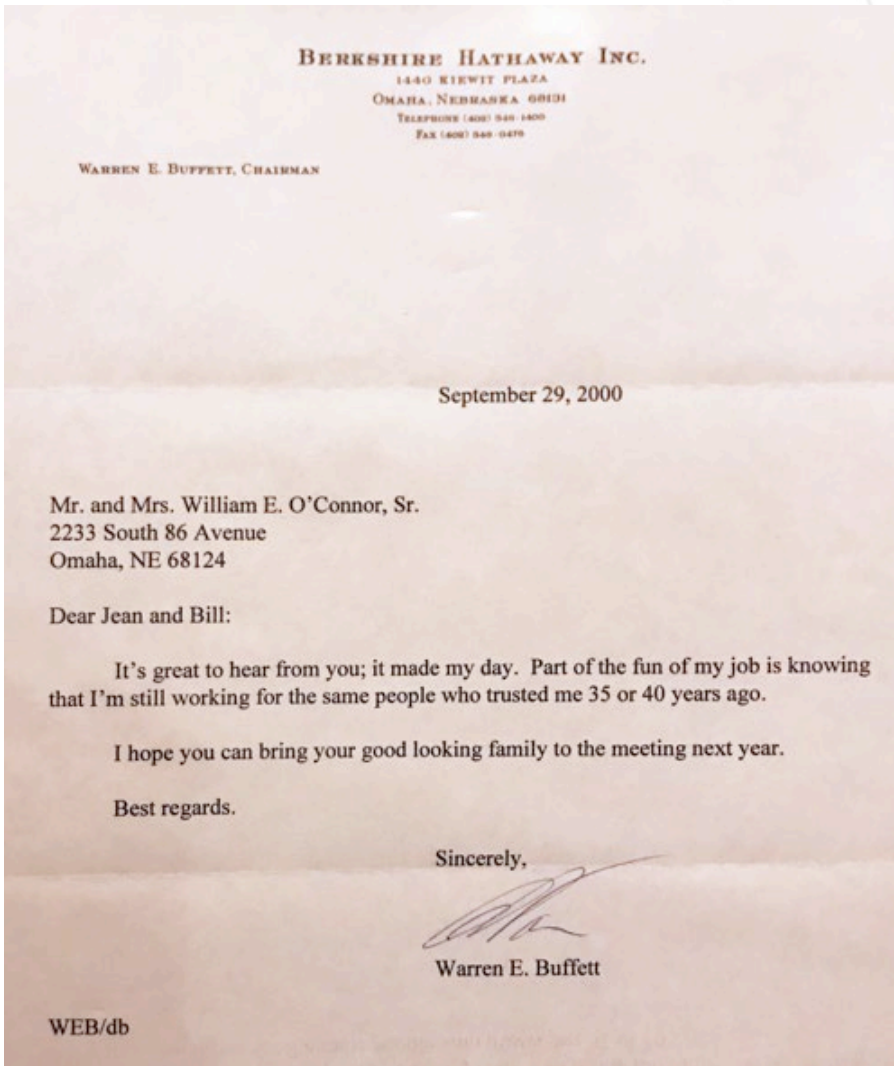
The importance of that lesson – of sticking with good people through thick and thin – is why the September 2000 letter on the following page, which hangs next to my desk at all times, is hands-down my favorite piece of Buffett memorabilia.[37] It's a reminder that 35 or 40 years from now, I'll be a lucky man indeed if I am still working for the same people who have placed their trust in me today. What better reminder could there be of what this "job" is all about? It's not about image or status or making myself rich. Rather, it's entirely about serving others, and making them wealthy enough to make a material difference in the same way the Buffett LP's (and Berkshire Hathaway) did for mine. In other words, it's about the chance to have a real, even transformational impact on their lives – not just today or tomorrow, but over decades. How many people get to do that?

(35) This wonderful piece by Chris Cerrone at Akre Capital hits the nail on the head: https://www.akrecapital.com/the-art-of-not-selling/

(36) The one time he did cash out a small amount of his Buffett investment, my grandfather laid the groundwork for yet another investing lesson – this time, about opportunity cost. About 35 years ago, he sold some stock and used the proceeds to add a deck to our family's lake house in Iowa. It's a nice deck, but the shares he sold to build it would today be worth over $10 million. Ouch.

(37) Another piece of Buffet memorabilia in my collection is shown on the cover page of this letter. It's a map of the street on which I now live – and it was made long ago by the Sanborn Map Company, one of Buffett's early "control" investment successes.

Years later, when I was fresh out of college, I asked my grandfather why he had never diversified his investments away from Buffet's LPs and Berkshire Hathaway. What gave him such incredible confidence? After the umpteenth doubling of his money, why hadn't he taken some profits off the table? Why hadn't he listened to the dozens of solicitous investment advisors who told him year after year, decade after decade, that it was well past time to start diversifying his portfolio?



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WARREN E. BUFFETT, CHAIRMAN

September 29, 2000

Mr. and Mrs. William E. O'Connor, Sr.
2233 South 86 Avenue
Omaha, NE 68124

Dear Jean and Bill:

It's great to hear from you; it made my day. Part of the fun of my job is knowing that I'm still working for the same people who trusted me 35 or 40 years ago.

I hope you can bring your good looking family to the meeting next year.

Best regards.

Sincerely,

Warren E. Buffett

WEB/db

However, that letter isn't just a reminder of the duty I have to those who've entrusted Crossroads with their hard-earned savings. It's also a reminder of the sheer magnitude of the task at hand. It never fails to humble me when I'm feeling particularly clever or proud. In fact, it usually keeps me from feeling clever or proud in the first place. We've had an incredible first four years here at Crossroads, but four years is nothing when stacked up against Buffett's 60-plus-year career. We've still got a job to do – and the reality is we've barely even gotten started.

Still, it's true that Crossroads has done well in these early years. Starting over four years ago with approximately one million dollars and the backing of a single family, we now manage over $17.5 million for nearly a dozen investors. We're doing what many people said could not be done: scaling a fund to sustainability with essentially zero marketing and building a track record that's second to none. Our future as a firm has never been brighter or more secure. Indeed, our best days are yet to come.

I say that without any special insight into how long COVID-19 precautions will continue to hamper the economy, or whether the market is headed up or down. But I firmly believe it doesn't matter. At Crossroads, we'll continue to build our portfolio one exceptional idea at a time, designing it to hold its own in any market environment. If we can continue to execute, and I believe deep down in my bones that we can, we'll do just fine.

I'd like to end this letter with a quote from a friend and fellow fund manager I've long admired who became one of our major investors this past year:

> *"As volatility arises, I will attempt to take advantage of the opportunities it creates. We will continue to invest with a long-time horizon, and we will continue to invest like it is our own money – because it is. Thank you for the opportunity to grow your family capital alongside mine."*

We couldn't have put it any better. Thank you for your continued support.

With our best regards,

Ryan O'Connor
Founder and Portfolio Manager
Crossroads Capital, LLC

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