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Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide a brief overview of one new equity holding: Edison Nation (EDNT). A brief summary of the letter is as follows:

- Wall Street expectations, be it economic data, earnings growth or political outcomes, appear to be fairly high. This is the inverse of conditions experienced at the start of 2019.
- Investor sentiment is bullish and CEO confidence is improving. This is also the inverse of conditions experienced at the start of 2019.
- For the time being, the US and China appear to have declared a trade truce while laying the framework for a multi-stage, multi-year, comprehensive deal.
- US employment and wage growth data continue to be very strong. It is difficult to envision a prolonged economic slowdown with a strong US consumer.
- Investors are expecting the Fed to continue their accommodative rate stance.
- The Democratic primaries continue to show more liberal (Warren, Sanders) candidates taking ground from the presumed moderate front runner (Biden). Wall Street is wary of a non-Trump winner, and appears particularly unfound of Sanders and to a lesser degree Warren.
- For now, impeachment appears to be mostly background noise, but the prospect of a "smoking gun" that cannot be ignored always looms.
- Coronavirus outbreak could be cause for concern. In 2002, the market sold off ~10% following the SARS virus outbreak.

2019 Recap and 2020 Outlook

2019 was a very good year for equity investors as the three major indexes all returned in excess of 25% and effectively closed out the year at all-time highs. As the saying goes, "all-time is a long time". As usual, a little context is needed on 2019's performance. The end of 2018 was very rocky and saw the market fall ~20% from October through December of 2018, thus 2019 began as a rebound from the worst December since the Great Depression. The S&P 500's two year gain is a more modest, yet still strong, ~16%.

At the start of 2019, investors were defensively positioned, sentiment was poor, CEO confidence was at levels not seen since the 2009 financial crisis, and very few expected a strong 2019. Interestingly, one could argue the market ignored a good deal of negative news in 2019. Consider the following:

1. China's GDP decelerated to the lowest level of growth in 29 years.
2. US economic data was choppy, at best, with notable weakness in the industrial/manufacturing sectors as well as housing and automotive.
3. Iran "attacked" a jointly occupied American Iraqi base in retaliation to the US' killing of Qasem Solelmani (Iran's top commander, who was designated as a terrorist by the US) and subsequently accidentally shot down a Ukrainian commercial jet killing 176 civilians.
4. Evolving issues and uncertainty around Brexit.
5. The impeachment of President Trump along with a seemingly never ending amount of political noise surrounding the administration.
6. Trillions of dollars in negative bond yields.
7. Effectively zero S&P 500 earnings growth in 2019 ($143.90/sh to $149.60/share)

An interesting summation of the past two years comes from Goldman Sachs' trading desk[1]:

> *"…the challenge of 2018 was that it featured some of the very best growth of the entire cycle ... yet, that growth was met with a down year for the stock market and a complete absence of meaningful return across the entire asset spectrum ... this year was the photographic negative: despite slower global growth, 2019 played out as one of the highest quality years in the history of financial markets.*

To quantify that statement, 2019's S&P 500 total return ranked in the 93rd percentile historically for the index. A few other interesting points on 2019[1]:

- Since 1928, the average annual price return of the S&P 500 is 8% and the realized volatility[2] is 16%. Said another way, compared to history, the market delivered nearly four times the average return on 80% of the average volatility.
- The S&P 500 began the year trading at 14x forward earnings and finished it trading at 18x. With basically 0% earnings growth in 2019, effectively all of the S&P 500's gain came from multiple expansion.
- The worst peak to trough decline was 7%, which is about half the annual median of 13% (dating back to 1928).
- The S&P 500 traded higher on 60% of days in 2019, which ranks in the 97th percentile since 1962 and the best since 1995.
- 90% of S&P 500 stocks posted positive returns, including 333 companies up 20% and 81 companies up 50%. Only 45 stocks declined, with just 11 down >20% and none down 50%.
- The worst performing sector was Energy with a 12% gain followed by Health Care with a 21% gain.
- The best global stock markets were Greece (+53%), China A-shares (+39%) and Russia (+38%).

Certainly a heck of a year. For those interested, **Appendix Figure 1** shows the 2019 returns for various sub-sectors of the S&P 500 as well as a variety of other asset classes.

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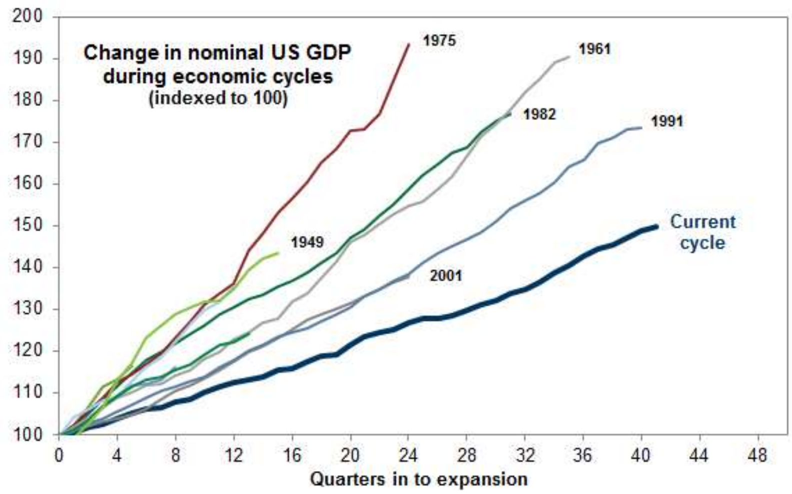
[1] Goldman Sachs "2019: against expectations, a supurb year for markets" email dated 1-2-20

[2] Basically, the amount of annual market volatility actually experienced vs. the daily market volatility experienced. A lower number implies lower volatility.

As these data points have been laid out to our clients in year-end meetings, the first question is almost always: Why did the market ignore it all?

We believe most market participants felt 2019's weakness was primarily, if not solely, the result of the ongoing uncertainty centered on Chinese trade. Essentially, once trade is no longer an issue, business sentiment will pick up, economic activity will increase, and GDP in the US and abroad will begin to reaccelerate and stay on trend. Given that many felt trade would ultimately be resolved, it arguably makes sense that investors would simply ignore the present and focus on the future.

The following chart shows the current economic expansion cycle. It is both the longest, and slowest, on record. At some point, the cycle will falter or, perhaps, end completely.



At present, one of our primary concerns is: What if the sluggish 2019 economic data was <u>not</u> caused by trepidation around trade and it is simply the cycle slowing? If the market has risen substantially in anticipation of a rebound in economic activity, and it does not come to fruition, it is likely to create a poor backdrop for the stock market. Additionally, there is a measure of US election risk (both upside and downside) to take into account as we draw closer to November.

Even if global economic activity does accelerate, it is our opinion that, given how much the market priced in during 2019, investor expectations are probably higher in 2020 and it will likely be more difficult to produce another exceptional year for stocks. While we have not made many changes to the portfolio over the past quarter, our bias has been to raise cash and lock in gains for clients with a more conservative investment profile.

A quick note on the recent coronavirus outbreak, which is taking a toll on a variety of companies tied to China. In our case, Las Vegas Sands (LVS) a casino operator with significant exposure to Macau, has come under pressure. We like the long-term outlook for LVS, so we have chosen not to adjust our exposure. The closest analog to the current situation is probably the SARS epidemic of 2003, which caused a ~10% decline in the S&P 500, but was recovered once the World Health Organization began lifting travels bans and quarantines. Of note, SARS is a type of coronavirus, though seemingly less contagious than the current iteration. Wall Street tends to be fairly myopic in the short-term, but the primary fear seems to be that a prolonged outbreak will have a negative impact on – at the very least – Chinese economic activity and perhaps disrupt supply chains and therefore also ding global growth. Certainly possible, but also unlikely to have a major long-term impact.

Admittedly, the preceding paragraphs read more negative than positive. Our intent with this letter was to focus more on what could go wrong and what we think needs to happen for the market to continue higher. There are certainly many positives, particularly in the US (accommodative Fed policy, historic low unemployment, solid wage gains, a strong consumer, and modest year-over-year economic comparables), that are supportive of growth and likely higher stock prices. These have been the primary drivers of the post-financial crisis expansion, and should they continue, the market will likely reward investors.

We hope our readers have enjoyed this portion of the letter. The following section contains an overview of one new equity holdings.

All the best,
Long Lake Capital Management, LLC

Select Equity Holdings Update

For first time readers of this letter, we aim to make the equity update readily understandable for clients that may not have a background in finance.

Edison Nation (EDNT, $2.33/sh, $14M market cap)

Edison Nation is a very small, but interesting company, which operates a business model similar to CNBC's hit show, *Shark Tank*. On *Shark Tank*, a panel of judges (Mark Cuban, among others) assess the merits of an inventor's idea and decide if they would like to invest their own capital into the business in exchange for owning a percentage of the business or by receiving production royalties. Interestingly, of the handshake "deals" made on the program, over 80% are not actually executed once the cameras are off.

Edison Nation has a yet-to-be-released television show called *Everyday Edisons*, which is conceptually similar to *Shark Tank*, but instead of celebrity judges taking a piece of the economics, *Edison Nation* will help an inventor bring their idea to market via relationships with major brick and mortar retailers and a partnership with Amazon. If readers of this letter watch PBS, they may recall *Everyday Edisons* ran on the network for six seasons beginning in 2008. The new version of *Everyday Edisons* will stream on a "major SVoD[3]" starting February 11th, which is Thomas Edison's birthday.

Currently, Edison Nation operates an online inventor community, maintains a licensing agreement with Walt Disney[4], has a handful of existing production/retailing agreements with inventors, and produces a number of wholly owned products (primarily in the childcare space). The online inventor portal is subscription based and allows inventors to submit ideas, which are then vetted by the community and Edison Nation. The upcoming launch of *Everyday Edisons* should raise awareness of the inventor platform and effectively flips the company's advertising from an expense to a profit center. Unlike *Shark Tank*, *Everyday Edisons* aims to vet a handful of products each episode with a panel of judges selecting a winner each round (similar in concept to HGTV's *Chopped*). The winning invention can then be taken to market by Edison Nation.

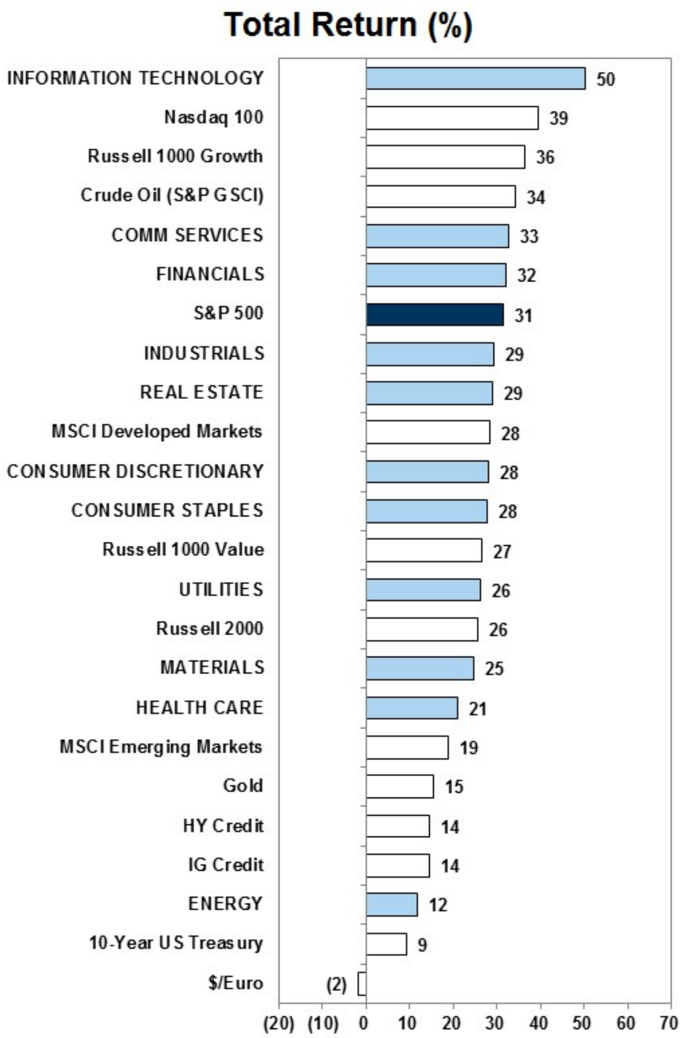
Edison Nation's CEO is Chris Ferguson. Among other ventures, Mr. Ferguson founded FTE Networks (publicly traded under FTNW) and ran The Florio Group, a private equity investment company backed by former New Jersey governor James Florio. Mr. Ferguson's salary is a very modest (for a CEO) $120K per year and he owns almost 30% of Edison Nation's equity. Of note, insiders own over 50% of the stock and have been active buyers heading into the re-launch of *Everyday Edisons*. Management with significant "skin in the game" is an attractive attribute of the investment thesis.

We think a successful launch of *Everyday Edisons* should serve as an inflection point for the company and makes an attractive entry point for investors.

[3] Streaming Video on Demand (i.e. Netflix, Hulu, etc.)
[4] Primarily princess wands sold at Shanghai Disney

Appendix

Figure 1



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