January 29, 2021

To the Partners of BlackBird Financial LP:

COVID-19 has caused an acceleration, deceleration, or reversal of many long-term trends. In dealing with new developments, BlackBird is distinguished from most of our competitors in that instead of trying to capitalize on change, we invest in companies that are relatively immune to it. As Ben Graham wrote in Chapter 4 of *Security Analysis*, “For investment, the future is essentially something to be guarded against rather than to be profited from.” While Wall Street may find this approach boring, I’d rather be rich and bland than exciting and poor. For this reason, we did not buy into businesses that were likely to benefit from the pandemic; rather, we sought after businesses that we understand and that are predictable, conservatively financed, and possess significant competitive advantages, thus earning high returns on invested capital, all for a price which affords us a wide margin of safety and a satisfactory prospective return.

“In chaos, there is fertility”— Anaïs Nin. The good news is that 2020, with all its crises, provided us ample opportunity to make such acquisitions, more so than in years prior. On March 18, 2020, I sent out a letter entitled *CoronaVirus at BlackBird* urging all of you to invest any capital you could spare. It read in part:

> “I have good news: that day has arrived! While I’m not proposing that market quotations will be higher in a week, a month, or even a year, I am saying that many wonderful businesses are selling for significantly less than they are intrinsically worth. Obviously, it is not easy to buy when the world is in a panic and there is no definitive end in sight. But we are also not the average partnership. Every one of our limited partners is far more rational than the average citizen. Additionally, we all have a long-term mindset. We are concerned about building wealth for our families and ourselves, not what the headlines will read next week. If there is a partnership in the world that is apt to take advantage of this moment, it is BlackBird.
>
> If you have money that has been sitting on the sidelines, now is the time to put it to work. Your courage will be richly rewarded.”

My confidence in you was not misplaced. Commendably, many of you had the courage to make additional investments at that time, and have indeed realized significant gain.

Because of these capital inflows at such an opportune moment, our money-weighted returns significantly outperformed our time-weighted returns, a rare phenomenon in this business. Typically, money managers receive large inflows when recent returns have been high and thus prospective returns are diminished, and significant redemptions when prices have fallen and investment opportunities abound. This is one reason why mutual fund investors have historically underperformed mutual funds themselves. As Warren Buffett has often advised, "Be fearful when others are greedy and greedy when others are fearful." Mahatma Gandhi said that "An ounce of practice is worth a thousand words." The truth is even better — it's worth millions of dollars! To me, the fact that we did act rationally amid panic serves as a testament to the temperament of the limited partners whom we have carefully assembled. No doubt this attribute will prove its value over the coming years and decades. I feel extremely fortunate to be working in such company.

In Chapter 8 of the *Intelligent Investor*, Ben Graham writes:

> "Since common stocks, even of investment grade, are subject to wide fluctuations in their prices, the intelligent investor should be interested in the possibilities of profiting from these pendulum swings. There are two possible ways by which he may try to do this: the way of timing and the way of pricing. By timing we mean the endeavor to anticipate the action of the stock market-to buy or hold when the future course is deemed to be upwards, to sell or refrain from buying when the course is downward. By pricing we mean the endeavor to buy stocks when they are quoted below their fair value, and to sell them when they rise above such value. We are convinced that the intelligent investor can derive satisfactory results from pricing. We are equally sure that if he places his emphasis on timing in the sense of forecasting, he will end up as a speculator and with a speculator's financial results. This distinction may seem tenuous to the layman and it is not commonly accepted on Wall Street. As a matter of business practice, or perhaps of thoroughgoing conviction, the stock brokers and the investment services seem wedded to the principle that both investors and speculators in common stocks should devote careful attention to market forecasts."

In accordance with Graham's teachings, BlackBird does not attempt to time the market. We make no predictions as to near-term price changes. While precise timing would indeed enhance returns, we do not possess that superpower.

2020 provided several examples of this practice; in early March, as prices declined broadly, we began buying heavily. Many "professionals" advised to hold off on such activity until the virus spread more widely and pummeled prices further. With each passing day we experienced heavy quotational losses, yet we continued to buy. We did not attempt to time our purchases. The company and price were right, and we swung into action. Would we have gotten an even better deal if we had held off a week on some of those transactions? Of course! But we would have payed a hefty premium had we held off a month, and no one had any idea as to when that nadir would occur.

To provide another example, as the year came to a close, many pundits were concerned about how a Democratic win in the election and any ensuing disputes could affect prices. Though both of those events took place, prices *advanced* significantly in November and December. To quote Donald Rumsfeld, who served as Secretary of Defense under the Bush administration, "As we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know." At BlackBird, timing is a known unknown.

Investment Approach

Many people have asked me what differentiates BlackBird from the multitude of investment partnerships/hedge funds that supposedly operate in a similar manner, yet never match our results. The answer boils down to three key factors:

1. **We look to the underlying business to ascertain its value, not the stock price.** In other words, most of Wall Street is engrossed in the short-to-medium-term price movements, momentum traders will be interested in a stock at the upper end of a 52-week range, contrarians will prefer those at the lower end of said range, and academic types will seek low price volatility because they use beta (a security's price volatility in relation to the general market) as a risk gauge. Whichever their perspective, their buy-sell decision is heavily influenced by Mr. Market's recent mood swings. BlackBird, in contrast, does not heed price fluctuations. Instead, we concentrate solely on the underlying business and whether it can be acquired at a discount to its intrinsic value.

2. **We hold a concentrated portfolio.** Many managers have come to believe that the more widely you spread your investment capital, the lower your risk. In reality, this approach results in a diminished understanding of each position, which elevates risk! Additionally, investing capital in your fiftieth best idea instead of adding to your first is not an intelligent practice. In contrast, we are extremely selective in our acquisitions. We would rather own a handful of businesses with wide economic moats, a conservative capital structure, high returns on invested capital, and an investor-friendly management team all for a bargain price than 100 commodity-type businesses with mediocre management, low returns on capital, and at a high price.

3. **We take a long-term approach to investing.** Here is an example to illustrate the distinction: "Headline risk" is a term often used by Wall Street analysts. Traders are concerned that headlines in the near future will adversely impact stock prices. To demonstrate what a fallacious mindset this is, let us imagine you were offered a pristine apartment complex in a safe, growing community with strict limits on new supply, providing current annual income of $25 million, all for a meager $100 million. You would work very hard to quickly consummate such a transaction. Certainly, one would need to be an ignoramus to turn down the offer simply because there may be a critical headline next week! Why, then, should businesses be any different? Maintaining a long-term view enables us to concentrate on the underlying business without being distracted by the ample noise found on Wall Street.

These three points can be summarized as a *businesslike approach*. As Ben Graham writes in Chapter 20 of the *Intelligent Investor*, **"Investing is most intelligent when it is most businesslike."** That is at the very foundation of BlackBird. We will never waiver.

Great versus Mediocre Businesses

A great business is one which can deploy large amounts of capital at high rates of return. Imagine we have $10 million we want to invest for the next 15 years. There are two companies available to us, Everest Inc. and The Dead Sea Corporation. Their figures are as follows:

	Everest Inc.	The Dead Sea Corp.
Trailing 12-month Earnings	$10 million	$25 million
Current Market Cap	$250 million	$250 million
P/E Ratio	25	10
Earnings Yield	4%	10%
Return on Equity	20%	10%
Current Equity	$50 million	$250 million
Dividend Yield	0%	5%
Payout Ratio	N/A	50%

Let us assume that when we receive our dividends from TDSC, Uncle Sam decides that he doesn't want our money, and we use the full amount to acquire additional shares on the open market. Not only that, but when it's time to sell in 15 years, there is a sudden increase in the earnings multiple, from 10 to 15. Everything is working in our favor! On the other hand, if we buy Everest Inc., there are no dividends to speak of. When we come to sell, investors are less enthusiastic about Everest's prospects than they once were, and the P/E ratio contracts to 20 from 25. Horrible, isn't it?

Now let's look at our results:

	Everest Inc.	The Dead Sea Corp.
Total Investment Proceeds	$102,713,477	$58,806,656

Despite the higher price multiples and headwinds for Everest and the "cheap valuation" and tailwinds at Dead Sea, our total profit is 90% higher in the former company. Such is the power of a wonderful business. While BlackBird is not willing to pay an infinite price for any asset, when we find a great business available at a fair price, you can bet we will be buying.

Rise of the Retail Trader

One of the interesting developments in 2020 relates to the growth of the retail trader. As platforms such as RobinHood began offering user-friendly, free trades, millions of people across the country have made stock trading their go-to pastime while trapped at home. Citadel Securities, the top retail US equity market-maker, executing 41% of all US-listed retail volume, reported that individual market activity now accounts for 20 to 25% of overall market activity, up from 10.1% in 2010, and 14.9% in 2019. Many of these traders/gamblers could not differentiate between an income statement and a balance sheet and have never read through an annual or quarterly report. Yet, despite their inexperience and lack of business intelligence, they feel like geniuses when the paper profits come rolling in. Very little in this world sedates rationality like large doses of effortless money. After an exhilarating experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities, that is, continuing to speculate in companies that have enormous valuations relative to the cash they are likely to generate in the future, will eventually end in pumpkins and mice. But they nevertheless hate to miss a single minute of an amazing party. Therefore, the giddy participants all plan to leave just minutes before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands!

As was the outcome after the speculative environment leading up to the crash that began in September 1929, the precious metals frenzy at the end of the 70's, the infamous dot-com bubble in 1999, and the real estate boom leading up to the 2008 recession, there will come a reckoning, though exactly when remains unclear. The good news is that after each of the aforementioned bubbles popped, the immense selling pressure caused the pendulum to swing too far in the opposite direction, offering wonderful businesses/assets for great prices. With a large amount of cash on hand, we will be in a position to capitalize on that development when it occurs. As Bobby Unser, one of the best Indy 500 racers of all time, once said: "Success is where preparation and opportunity meet."

The Team

I'm happy to report that we have added five newcomers to our team. All of them help prospective partners learn more about our investment approach and ultimately are of enormous help with the onboarding process. Their compensation is very generous and directly linked to their accomplishments, which helps align their motives with that of the Partnership. As you have come to expect from us, they have not and will never be paid out of your pockets. All of our operating expenses continue to be paid from the standard management fees.

We continue to seek talent, and if you know someone who might be a good fit for our team, please do not hesitate to recommend them.

Long-term Outlook

I'd like to reiterate my warning from last year's annual letter regarding future investment returns over the coming decade or two. Over the last 40 years, we experienced a dramatic fall in interest rates (from roughly 15% 10-year treasury yields at its peak in 1981 to about 1% at present) which helped boost asset prices. We also saw increased corporate profits as a proportion of GDP, from 5% in 1970 to more than 9% in 2019. There has also been a major decrease in the United States Federal corporate tax rate from 46% at the start of the 80's to 21% today. Additionally, we've seen a general increase in optimism that was sorely lacking as the 1970's came to a close (causing multiple expansion). Each of these tailwinds are unlikely to strengthen indefinitely, and may even develop into a headwind in the future.

Jack Bogle, founder of The Vanguard Group and commonly known as the Father of Index Fund Investing, devised a simple, yet somewhat useful framework to set return expectations. It adds the return from three components:

1. Dividend yield
2. Expected nominal growth in earnings
3. Speculative return (multiple expansion or shrinkage)

At present the S&P 500 dividend yield is roughly 1.5%. If we assume that nominal GDP growth averages 4% and that corporate profits move in sync, we are left with a return from investment (first two components combined) of roughly 5.5%. Given the discussion above, a 0% speculative return may well be too optimistic, though we'll use it for this discussion. While a return of nearly 6% compares favorably in relation to the 1.1% available today from treasuries, it is far less than the 11.75% average from 1980 to 2020, with dividends reinvested. This calculation is imprecise, and, while I have great respect for Mr. Boggle, I believe it's also incomplete. Even so, I think it's at least somewhat useful in keeping expectations in check. While BlackBird exists to exceed average returns, and has continuously accomplished just that, we are subject to the general market, and so you should adjust your expectations accordingly. Just so the mood doesn't get too gloomy around here, we should remember that if inflation remains at historic low levels, the real (buying power) return may not be too disagreeable.

Values

There are three guidelines that we have and will continue to operate under:

1. Our investments will be chosen based on the value-to-price relationship, not popularity.
2. Our investments will attempt to reduce the risk of permanent capital loss to a minimum (which is why I am comfortable with rule # 3).
3. I will have more than 95% of my net worth invested in BlackBird (never trust a cook who won't eat his own food).

As John Maynard Keynes once said, "In the long run, we are all dead." Until then, there is money to be made and lives to be lived.

Your fiduciary, Judah Spinner
Chief Investment Officer