



November 18, 2020

## Ignition

Dear Client,

It certainly is a bizarre feeling observing the strength in our investment portfolios amidst the backdrop of an unprecedented global pandemic and recession; however here we are. In the third quarter, our portfolios continued the strong trend established in the second quarter. One might think we avoided owning “COVID losers” heading into this period from the results; however, that is actually far from the case, as we have held a few of these positions through the worst of the COVID Crash, while shedding others in favor of more timely opportunities.

We have always proclaimed a key function of portfolio management as positioning a portfolio of businesses such that irrespective of what path the market takes over any shorter time period, we have the ability and temerity to see our best ideas through. We think the strength speaks to the kind of businesses we have focused on investing in and the extent to which we concentrate our portfolio, while maintaining an appropriate level of diversification. We have always believed it is more important to diversify the risk factors to which our companies are exposed, rather than merely diversify by aiming toward a certain number of securities in our portfolios. To that end, we have seen portfolios of hundreds of securities that are less diverse than ours with a central tendency towards twenty-five companies.

### **Seasons of Change**

With a few more months of living with COVID under our belts, we have more information at our disposal to form opinions on how our economy and ecosystem of companies will fare; however, we are cognizant that summer presents drastically different realities than the colder weather of Fall and Winter. To that end, while we feel society settling into a new normal, we are cognizant that one more season of change may be upon us as the heat of Summer gives way to the cooler temperatures of Fall. Perhaps the foremost silver lining of the new realities COVID has imposed on us is how people are finding more ways to spend time outdoors than in the past.

As the weather changes, in an effort to comfortably extend the outdoors season, we find ourselves appreciating the warmth of a well-constructed campfire. The role of fire as one of the four core elements, underlying all of our existence, dates back to the ancient Greeks. Sitting beside a campfire, we can feel a connection to our oldest lived ancestors who first harnessed this awesome power in a way to transform our species from merely another Great Ape into a force called “humanity.” We also find ourselves appreciative of the mesmerizing and enthralling visual dance fire performs as our bodies soak in the radiant heat.



The key point in transforming the mere act of burning fuel (firewood in the case of a campfire) into fire is called the “auto-ignition temperature” or “kindling point.” As a fire crosses this auto-ignition temperature, the act of burning transforms into a self-sustaining fire that will perpetuate so long as we continue adding fuel, in this case, wood. There are two interesting parallels we would like to draw with investing, especially in the wake of COVID that offer valuable insights into where we are investing incremental cash and why we think a few of our strong performers actually present better risk/reward today than they did even at lower prices.

*The act of building:*

If you want to start a fire with regular logs, you cannot merely put some newspaper, pile the big pieces of wood on top, and strike a match. If you want to start the fire efficiently, your best approach is to start layering together much smaller tinder on top of your newspaper, building up to slightly larger pieces of kindling and then perhaps even one more layer of larger kindling. Once you get this initial foundation burning and to the ignition temperature, you then can add on your larger logs.

This key principle has parallels in company building as well. Some companies are designed from day one to attack large markets; however, the successful ones are unique exceptions. Alternatively, many companies today are encouraged to develop a “minimally viable product” and go after a segment of early adopters. From this position, the company takes lessons from early users, enhances the product, solicits further feedback from the early adopters and a slightly larger customer-base before again taking a further step on the path to more scale.

We have developed a growing affinity for companies that take many years in the testing and learning phase with their product, proving unit economics first and then taking aim at scale. In effect, these companies are honing in on and refining their core offering, building towards and then proving unit economics, and developing an engine to feed more fuel (some combination of marketing and research and development spend) in order to strive for something much bigger. Growing is thus a matter of scaling proven unit economics, not using scale as way to make unit economics work.

In many respects, companies that spend many years on this path end up with a much firmer foundation, built layer upon layer, than those that aim for and launch toward the clouds at birth. That launch would be akin to starting a fire with the logs before the kindling and while that may be possible, especially when using a starter log, the structural soundness and inner “heat” is not the same as when the slower, more methodical path is traveled. Importantly, the firmer the foundation, the stronger the moat as the industry marches towards mass adoption and then maturity.

Roku is an outstanding example of this in action. Roku was founded by Anthony Wood in 2002, its first streaming player was released in 2008 and the company IPO’d in 2017. Two other companies that IPO’d in Roku’s 2017 class are Snap, Inc and Blue Apron, founded in 2011 and 2012, respectively. While all three



IPOs were of the same public vintage, each of their back stories varied considerably. Of the three, Roku stands out as a company built with a strong foundation where the IPO itself was an act of leaning into its strengths, scaling proven unit economics and using its public status as a way to amplify and accelerate emergent competitive advantages, rather than merely providing liquidity for investors or accompanying a changed mission and focus. The IPO happened right at that point of ignition; however, the market had yet to appreciate its reality given hardware revenues still at that date exceeded platform revenues. This provided a compelling investment setup, whereby the ignition was underway and unappreciated at the same time.

*The point of ignition:*

The point of ignition is the very moment when the act of burning turns into self-sustaining heat. Companies can spend many years putting the pieces in place to reach a state where ignition becomes possible. Many times, a well-built campfire foundation is enough to ensure a great fire; though sometimes a slight breeze is needed to add oxygen and combustibility to the situation. COVID has been just such a breeze for many businesses that we have invested in and/or have been watching for some time.

While we would contend the companies we focus our investments in are past the point of ignition and well into the self-sustaining phase, for the purpose of drawing out this analogy, we think there has been a second ignition moment. For many of these businesses, several years of future growth were pulled forward and various hypothetical company product roadmaps were immediately brought into the forefront of reality. A great example of this in our portfolio would be QR code checkout at the point-of-sale for PayPal and Venmo users. Importantly, PayPal had been building this functionality and expanding their capabilities in anticipation of such a reality being within the realm of possibilities, though we were never willing to write that into our analysis. The winds from COVID have offered a helping hand in igniting this situation, transforming possibility into actuality.

Similarly, the breeze from COVID has had a profound impact on Roku, with the early lockdown period bringing a second “Holiday Shopping Season” worth of new Active Accounts and an accompanying hockey stick-shaped surge in the number of hours a day each household watches through the company’s operating system. For these reasons, we meaningfully increased our position early in the quarter.

**Our new position:**

Our investment process itself follows the campfire analogy. Every day we do work building the kindling, digging in deeper laying the logs in place, warming up to an idea before that point of ignition—the moment when something goes from a compelling idea to an actual investment. Many of the ideas we nurture burn out of fuel before truly igniting, while our best ideas are those where the fire roars with conviction. To that end, this past quarter we commenced a new position. Our work on this position began before COVID and for a while, we thought it “got away” during COVID, though the more we visited and revisited the



rationale, the more we appreciated the opportunity. We are going to be tight-lipped about our new purchase last quarter in this section of the letter as we continue to round out our holding. That said, we think the company is an outstanding example of one that spent many years building a strong foundation, and unlike our examples of PayPal and Roku above, it was debatable whether there was a true “point of ignition” for further layers of scale. COVID has dramatically tilted the business past the ignition point and transformed the situation into a self-sustaining reality with years of fuel to burn in striving toward new layers of scale and opportunity. This is a framework we are deploying amidst COVID-induced changes: asking ourselves “which companies have now experienced a self-sustaining ignition where it formerly was unclear?” It is but one way we have used the tree branches of winners and losers from COVID outlined in our Q2 letter to inform directionally the kinds of opportunities we want to work on today.

**Elliot Joins the Podcast World:**

During the quarter, Elliot was humbled and honored to join John Mihaljevic of MOI Global, Chris Bloomstran of Semper Augustus, and Phil Ordway of Anabatic Investment Partners in founding This Week in Intelligent Investing (TWIII). TWIII is a weekly podcast where the four panelists engage in topical conversations on the investing process, interesting industries and companies, and timely investing topics. You can find TWIII on any of your favorite podcast services or play any episode from this [link](#).

Additionally, Elliot was featured on Andrew Walker’s fantastic Yet Another Value Podcast. You can listen to Elliot share our thesis on Dropbox [here](#).

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we have included our direct dial numbers with our names, below.

Warm personal regards,

A handwritten signature in red ink, appearing to read "Jason Gilbert".

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